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Financial reporting and standard setting : a symposium; Symposium on Financial Reporting and Standard Setting (1990 : Wharton School)

Gary John Previts

Symposium on Financial Reporting and Standard Setting (1990 : Wharton School)

American Institute of Certified Public Accountants

Financial Reporting and Standard Setting

A Symposium Sponsored by the
American Institute of Certified Public Accountants
at the Wharton School, University of Pennsylvania
Philadelphia, October 25-26,1990

Edited by Gary John Previts

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PHILIP B. CHENOK
President

March 1991

Dear Colleague:

Here is a publication of the Proceedings at a Symposium on Financial Reporting and Standard-Setting held at the Wharton School last October. The meeting was sponsored by the AICPA to explore a number of issues relating to the subject. Four background papers helped to set the stage for the discussion.

Russell E. Palmer, chairman of the Palmer Group and former Dean at the Wharton School, chaired the meeting; Shaun F. O'Malley, Managing Partner at Price Waterhouse and I served as discussion leaders. Gary John Previts of Case Western Reserve University, edited the publication.

According to Gary Previts, three significant conclusions can be drawn from the discussion sessions:

> Financial reporting must change. In order to remain relevant, its value-based and forward-looking information content must be enhanced. This may require a gradual re-engineering of the model.
>
> The type and amount of an entity's financial disclosure should be user-specific.
>
> While the FASB's mission statement appears appropriate for its present operations, it is not clear that the mission is appropriate if the reporting model is re-engineered and the Board's role is viewed as being more "global" and if technological effects on reporting are to be addressed in a proactive manner.

I hope you find the Proceedings interesting reading.

Sincerely yours,

Philip B. Chenok

PBC:jd
Enclosure

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Preface

The Symposium on Financial Reporting and Standard Setting was held at the Steinberg Conference Center of the Wharton School, University of Pennsylvania, on October 25 and 26, 1990. The meeting was sponsored by the American Institute of Certified Public Accountants. The program was chaired by Russell E. Palmer, chief executive officer of the Palmer Group and former dean of the Wharton School. Discussions were led by Philip B. Chenok, president of the American Institute of CPAs, and Shaun F. O'Malley, chairman and senior partner of Price Waterhouse. The symposium planning group included Messrs. Chenok, O'Malley, Palmer, Dennis R. Beresford, chairman of the Financial Accounting Standards Board, and Joseph J. Melone, president of the Prudential Insurance Company.

The background papers prepared for the symposium represented a variety of community perspectives: that of auditor (Robert K. Elliott, KPMG Peat Marwick), that of issuer/preparer (William J. Ihlanfeldt, Shell Oil Company), that of academic (the University of Southern California Financial Accounting Study Group, chaired by Doyle Z. Williams), and that of analyst/user (Gerald I. White, Grace & White, Inc.). The idea for the Wharton symposium derived from two previous gatherings, in November 1968 and November 1971, known as the Seaview Symposia. The symposia are believed to have been an important part of the process that led to the formation of the Study Group on Establishment of Accounting Principles (Wheat Committee) and the Study Group on the Objectives of Financial Statements (Trueblood Committee). These, in turn, affected the process and product of financial reporting and standard setting by giving impetus to the establishment of the Financial Accounting Standards Board and its conceptual framework.

The invited participants of the Wharton symposium represented a variety of constituent communities served by the Financial Accounting Standards Board. These included corporate board members; public-practice firm executives; members of the standard-setting and regulatory agencies; financial analysts; representatives of the banking, investing, and corporate communities; academics; and leaders of professional organizations.

The conference included brief introductory remarks by the chairman and the discussion leaders on Thursday evening. On Friday morning, the participants were divided into concurrent discussion groups that individually addressed the symposium's two topics, "Financial Reporting" and

"The FASB—Its Mission and Agenda." An afternoon session brought all participants together to recapitulate and evaluate the common issues relating to the two topic themes discussed in the morning groups. The editor's notes, as well as the presentation materials of the chairman and the discussion leaders and a transcript of the afternoon session, provided the basis for the summary reports of the discussion sessions.

These summary reports, one for each of the two conference subjects, represent the concluding "papers" of these proceedings. And in the sense that the four background papers provided vehicles for discussion, the summary reports seek to capture and assemble for readers the common issues, concerns, and views that emerged from this unique episode in professional self-evaluation. The constructive yet critical tone found in this material evidences the interest and sense of responsibility with which participants addressed the topics. For, as Chairman Palmer reminded them, "in the final analysis the Board's process is our process, and if we perceive that the Board has a problem then we all have a problem."

It was in this sense of community interest and participation that the symposium was conducted and that the proceedings are offered for consideration to a wider group in that same community.

You will find the introductory materials and opening remarks by the hosts to be important in achieving a full appreciation of the symposium materials. I encourage you to read the background papers and summary reports with attention, and I trust that you will find the material helpful in increasing your understanding of the important issues affecting the process of financial reporting and standard setting.

In concluding, I wish to express my appreciation to the authors of the background papers and to the chairman and the discussion leaders for their cooperation in assisting an expeditious publication of these proceedings. And I am also appreciative of the support of the AICPA staff, particularly Katharine Coveleski for her skilled editorial assistance.

GARY JOHN PREVITS
Weatherhead School of Management
Case Western Reserve University
Cleveland, Ohio

March 1991

Symposium Participants

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The Palmer Group

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Financial Accounting Standards Board

DONALD H. CHAPIN
U.S. General Accounting Office

PHILIP B. CHENOK
American Institute of Certified Public Accountants

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International Accounting Standards Committee

Contents

Executive Summary

The American Institute of Certified Public Accountants sponsored the Symposium on Financial Reporting and Standard Setting at the Wharton School in response to a perceived need to evaluate and discuss issues about financial reporting and standard setting among a representative group of knowledgeable and interested persons who would have had an opportunity to consider background papers and prepare for discussion of two topic areas, "Financial Reporting" and "The FASB—Its Mission and Agenda." These topics were informally referred to during the conference as relating to the "product" and "process" of the Financial Accounting Standards Board.

Financial Reporting

Two components were identified as relating to financial reporting: the current model and reporting standards. Thereafter, two principal questions were addressed as relating to these components. First, "Is the model and its product appropriate?" Second, "Should promulgated standards generally be broad or narrow?"

As to the first question, participants felt that while the model should not be scrapped, it should be "re-engineered." This would involve research as to what users of financial statements require and a recognition of the need to provide different levels of information and attestation to meet those needs. A core reporting model was discussed as a possible means to achieving these ends.

As to the second question, there was a uniform preference expressed for future standards to be generally more broad and less technically rule oriented. The long-term and gradual pace of a move to such standards was discussed in the light of a perception that standard setting, over time, demonstrates a pendulum-like behavior. (See illustration, page 65.)

A principal outcome of the symposium was the identification of a *core reporting concept* (depicted on page 63) that would provide the rationale for "re-engineering" the traditional statement-oriented financial reporting model. This concept was seen as providing a combination of possible reporting outcomes for reporting entities as warranted by each situation (e.g., small privately held companies vs. large public corporations). There was also strong support for a suggestion by preparer participants that as a part of future major standards projects the Board should consider, as a "rebuttable presumption," the need to conduct field tests as an integral part of proposing a standard.

The FASB—Its Mission and Agenda

An important consensus of the meeting was the *reaffirmation of the propriety of the private-sector process of standard setting*. However, one criticism from the preparer/issuer community was particularly sharp. It asserted that the perspectives of preparers and issuers often were not given sufficient weight in standard-setting deliberations. It was pointed out that the mission statement implies that each group—issuers, auditors, and users—is equally important as FASB constituents.

While many persons concurred early in the symposium with a view that "the mission is not the issue," as discussions progressed several matters related to the mission and agenda were identified as part of the linkage between the "product" and the "process."

Throughout the discussions, the changing global and technological environment in which businesses obtain capital, operate, and report was recognized as an ongoing factor that requires continual long-range monitoring and strategic review for standard setting.

It was further noted that the FASB's mission lacks a specific charge as to its international role. This matter and the need for reaffirmation of the primary role of the FASB in its relationship with other authoritative agencies, boards, groups, and committees involved in the financial reporting standards agenda and process led several persons to conclude that there was sufficient reason to propose a review of the FASB's mission statement.

Conclusions

Three significant conclusions can be drawn from the discussion sessions of the Wharton symposium:

1. Financial reporting must change. In order to remain relevant, its value-based and forward-looking information content must be enhanced. This may require a gradual re-engineering of the model.
2. The type and amount of an entity's financial disclosure should be user-specific.
3. While the FASB's mission statement appears appropriate for its present operations, it is not clear that the mission is appropriate if the reporting model is re-engineered and the Board's role is viewed as being more "global" and if technological effects on reporting are to be addressed in a proactive manner.

The need to re-engineer the reporting model and the prospect of reviewing the FASB mission statement, in turn, raise an issue that was not specifically addressed at the symposium, namely, "How should such efforts be undertaken, by whom, and when?"

Since the symposium was not oriented toward proposing specific recommendations but was more exploratory, seeking to identify criticisms or concerns and constructively engage in discussions about those topics, it must be left to the sponsoring organizations and constituencies of the Board, and to the Board itself, to begin promptly to consider appropriate responses to these matters.

Financial Reporting and Standard Setting—A Perspective

Remarks by Russell E. Palmer, *Chairman and Chief Executive Officer, The Palmer Group*

My brief remarks are intended to provide some background for our discussion groups. I can't help but remark that what we do here could be very important to our future and to the future of standard setting.

Standard setting began in earnest in the private sector, at least, with the activities of the Committee on Accounting Procedure, beginning about 1938. By the late 1950s, it had run its course, and a blue ribbon committee recommended the establishment of the Accounting Principles Board, which was operating by 1961. In 1973, acting upon the recommendations of the Wheat Committee, the Financial Accounting Standards Board began operation as the first full-time and independent standard-setting entity.

By 1977 the Congress, in particular, Representative Moss and Senator Metcalf and their staffs, had identified the "Accounting Establishment," and the FASB came under fire. The talk then, if you can believe it, was that the government should take over standard setting because the Board was the handmaiden of big business. Dark clouds were gathering, and these were very interesting times.

The Financial Accounting Foundation trustees undertook a comprehensive review, and I chaired that committee. In a year-long effort, we made several recommendations including opening up the board meetings, increasing communication with constituents, establishing a simple majority voting rule (because people said that not enough was getting done), eliminating the public practice majority on the Board, and requiring a greater role for the Advisory Council and its chairperson.

Shortly after the report was implemented, Don Kirk, who had been an original member of the Board, became chairman. About this time I was heavily involved, as a trustee for six years and trustee president for three years.

Lee Metcalf passed away and John Moss retired. Congress began to focus on other issues, and so the immediate matters were resolved and the Board was sustained.

More important, however, a major lesson was learned. What sustained the Board was its willingness to adapt to change and the willingness of its constituents to invest their efforts on behalf of the private sector role of the Board.

By 1984 there were the first attempts at governmental standard setting and, again, we at the Board learned to adapt and to work with its constituents. This was a particularly frustrating time for me, working with so many different governmental bodies and adapting to the differences between private and government accounting. And though conflicts later emerged, progress had been made.

Then in 1984 the Corporate Chief Executives' Business Roundtable began to express concerns about the Board and its operations. They lobbied for an independent review of the Board. Again the trustees, rather than cede their oversight responsibility to an outside group, initiated a review, including a broad-based opinion survey conducted by Louis Harris and Associates. This survey, similar to one conducted in 1980, found that the Board's acceptance rating had gone up from 73 percent to 88 percent. The trustees' reviews in 1985 and 1986 concluded that the Board's operation and its structure were functioning in a satisfactory manner.

Dennis Beresford became the Board's third chairman in January 1987. In 1988 a special group of trustees and other knowledgeable individuals, under the chairmanship of Ray Groves, again deliberated about constituent concerns. In March 1989, they recommended closer trustee and Board interaction and considered, but did not make, a recommendation to restore the 5 to 2 super-majority voting requirement for standards approval. They charged the Foundation Structure Committee to evaluate the voting requirement. [The super-majority requirement has been restored as of January 1, 1991.]

When the Governmental Accounting Standards Board was established in 1984, the structure agreement mandated a fifth-year review of the FASB and, similarly, of the GASB. In 1988-89 a trustees committee conducted a review of structure as a part of this mandate and concluded that "the current concerns of certain elements in the business community and public accounting. . .will be dealt with by the Financial Accounting Foundation Special Advisory Group, trustees and the FASB itself in a manner that serves the public interest."

During the past year, the members of the Business Roundtable's Accounting Principles Task Force raised concerns to the Board and the SEC, complaining that the number and nature of standards were too numerous and too onerous and that they hindered the "international competitiveness of American companies." In 1990, SEC Chairman Breeden, acknowledging that enhancing international competitiveness was one of the goals of his term, expressed an interest in learning more particulars from the Roundtable. Shortly thereafter, before a congressional committee, he strongly advocated "mark to market" accounting for assets of financial institutions and suggested that it should eventually become the method for other businesses. This approach, to say the least, was not warmly embraced by business.

Which brings us to this Wharton symposium. What has the review of the past two decades taught us about the Board's ability to survive? I suggest that two fundamental and important points can be made. The Board has been successful because it has consistently exhibited a willingness to change and it has received the participative support of its principal constituencies.

I compare this to the attitude, which has at times appeared at the Board, that might be said to represent a "siege mentality." It results from talking to insiders so much and becoming convinced that if only outsiders "really understood," then everything would be all right.

But the outside world is where the Board must really live, because it does not have a government charter or a legislative mandate and it depends upon its constituents for its financial support, its acceptance and its legitimacy.

We are pleased to have so many of the key Board people here with us for these two days. We look forward to the coming sessions and hope that they will continue the participative process that has been so important to the Board's progress and survival in the past.

Elements of the Accounting Model

Remarks by Shaun F. O'Malley, *Chairman and Senior Partner, Price Waterhouse*

These are interesting times. We are witnessing unprecedented changes around the globe as governments change, major realignments occur, and the prospect of a truly global marketplace becomes a reality. In this country, we've witnessed the rise and fall of entire industries within a few short years. Junk bonds and S&Ls are out; software developers and biotechnology are in.

One thing, however, doesn't seem to change. The standard setters, and their standards, are under attack. In recent years, that criticism seems to have been directed mostly at the FASB. Critics allege that FASB rules are too theoretical, overly complex, and costly to implement. A growing number of critics assert that the FASB, and its rules, lack relevance. They point out that the Board's projects take years, sometimes a decade or more, to complete. Yet, at the other end of the spectrum, there are those who say that even this pace of change is too great and that FASB initiatives are moving too fast, in too many directions. Some in the business community are beginning now to look to the International Accounting Standards Committee and world accounting standards as a possible source of relief from FASB requirements.

Tomorrow we'll have an opportunity to consider these and many other issues. This evening, Philip Chenok and I would like to take a few minutes to prime your thoughts for tomorrow's activities. As you know, we'll be discussing two broad topics. The first is financial reporting, and I'll lead the breakout group considering that topic. The second is the FASB, its mission and agenda. Phil will lead that group.

We have four excellent papers to aid our discussions. I am most grateful to each of our authors and appreciate their considerable and thoughtful efforts. While I recognize that we can't possibly begin to do the papers justice in just a few minutes this evening, I do want to highlight some thoughts affecting financial reporting which I found interesting. Phil will do the same regarding the FASB.

One thing that struck me as critical was that all four papers, in one way or another, suggested that financial reporting should reflect economic reality.

And, although they may have expressed slightly differing views as to the meaning of neutrality, that concept appeared to be a recurring theme, as was the need for the use of judgment in preparing financial statements.

Perhaps not surprisingly, all the authors alluded to the significant impact that technology is having, and will continue to have, on financial reporting. Elliott suggests the possibility of real-time measures. The USC Financial Accounting Study Group suggests that multiple-use data bases will result in the ability to focus on desired data, not just that data which the FASB has determined is best for the investor. White, as might have been predicted, would also welcome the availability of more and better data, but he cautions that data base users could be fooled if the information they analyze is not subject to the discipline of accurate measurement and reporting.

While no one seems quite prepared at this point to suggest that we totally scrap the historical accounting model, its relevance certainly has been questioned. The USC Study Group asks whether the stewardship focus inherent in the historical model remains relevant. They suggest that there is a need for a new accounting model focused more on current costs, changing price levels, risk assessment, and cash flows. Elliott reviews history, leading us through the agricultural and industrial eras to what he identifies currently as the "information" era. He sees a need for production of additional information and suggests a new focus for reporting, one that looks to rates of change. He would have us account for information assets such as R&D, human resources, and capacity for innovation, as well as increase our focus on risk. He also asks us to consider less emphasis on reliability and more on relevance. White would like increased access to all relevant information, even if relevant only to certain users. Ihlanfeldt, speaking for many preparers, suggests that possibly too much complex, irrelevant, and costly data is already required.

The effects of globalization were also discussed. Elliott reports that research and development expenditures rise and fall in the United States with each business cycle, possibly as a result of our current accounting system's failure to recognize such costs as assets. The USC Study Group calls for the U.S. to assume a leadership role in developing international accounting standards, lest the global marketplace reach the lowest common denominator and the U.S. find itself disadvantaged. And White observes that those who claim our accounting standards pose a significant barrier to foreign access to U.S. financial markets may be overreacting.

As to the future, all seem committed to the concept that standard setting belongs in the private sector. Ihlanfeldt suggests that users should have more input into standard setting. The USC Study Group and White seem to agree, up to a point. They part company, however, when Ihlanfeldt points out that business is both a preparer and user of financial statements and *its* views, therefore, should be given greater attention.

Ihlanfeldt makes another important point when he alludes to the cross-talk that occurs so often today. He notes that we all use the same words—"useful," "relevant," and "cost-effective"—but we really mean very different things.

There's certainly a lot to consider here. Those who prepared papers did an excellent job, and I look forward to our discussion groups and hearing your views tomorrow.

The FASB—Its Mission and Agenda

Remarks by Philip B. Chenok, *President, American Institute of Certified Public Accountants*

My objective this evening is to summarize comments in the background papers prepared for this symposium which deal with the FASB, its mission, and its agenda. More particularly, I will discuss the following questions:

- Is the FASB mission statement appropriate, and has the FASB been achieving its mission?
- How does the FASB balance the theoretical with the practical?
- How should the Board's agenda be set?

There appears to be a common thread in the background papers which suggests that changes are necessary to make financial reporting (and the FASB's process) more responsive to changes in the global marketplace, in technology, and in business operations.

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. The FASB is urged to see to it that financial information is useful (i.e., relevant, reliable, comparable, and consistent) and that financial reporting standards are current and reflect changes in methods of doing business in the economic environment. The mission statement requires the FASB to develop broad concepts (i.e., a conceptual framework) and standards based on research. The FASB is urged to be objective so that information is neutral, to weigh views of constituents but to retain ultimate decision-making authority, to be responsive to cost/benefit considerations, to minimize disruption, and to periodically review the effects of past decisions.

The background papers repeat several criticisms of the FASB:

- The FASB has lost some of its support.
- Differences of opinion exist between the FASB and the business community as to the objectives of financial accounting standards.
- Standards overload exists; i.e., standards are too frequent, too complex, too detailed, too much of a "cookbook," not responsive to cost/benefit considerations, and too conceptual and theoretical.

Comments on behalf of preparers seem to be somewhat mixed. We are told on the one hand that preparers are also users and that the FASB should give appropriate weight to realism and pragmatic considerations, and that the business community wants greater participation in the process. On the other hand, we are told that there are essential differences between preparer-users and external users, that external users have been under-represented in the process, and that the interests of users should take precedence over those of preparers.

There is also the question of international competitiveness. Some have suggested that the FASB (and also the SEC) have promulgated requirements that keep issuers out of the U.S. marketplace. Gerald White, however, advises us that many foreign issuers are quite anxious to enter our capital markets, even if not through the stock exchanges. At another level there is a concern that the globalization of the marketplace will create an environment where accounting and reporting standards could fall to the lowest common denominator. We are urged by White not to let that happen.

Finally, there is a concern that financial reporting isn't acting as an early warning system. Criticisms of auditors may in reality be criticisms that financial statements failed to adequately inform users of impending problems.

A number of suggestions are made for improving the process:

- Prospectuses for new projects.
- More effective use of task forces.
- Publication of preliminary views for comment.
- Use of field tests.
- Less due process, but use of due process to take items off the agenda.
- Less emphasis on detailed rules and more on general objectives.
- More stable financing arrangements for the FASB.

It is also suggested that support for the FASB be reemphasized in the face of competition from other groups such as the Emerging Issues Task Force, the AICPA, and, perhaps, the International Accounting Standards Committee (what White describes as the deregulation of accounting principles).

The FASB's future agenda makes for an interesting dichotomy of views. William Ihlanfeldt believes that the present agenda is more than adequate to keep the FASB occupied and that several of the current projects could result in changes in the current accounting model. (By inference this may be an acknowledgement that the model should change.)

On the other hand both Robert Elliott and the USC Financial Accounting Study Group suggest that financial reporting should be "re-engineered." They point out that a number of changes are taking place:

- We are moving from an industrial to an information era; we need to measure information assets and report rates of change.

- We need to move away from stewardship notions and embrace asset value and risk.
- We need to give greater attention to prospective information.
- We need to recognize that financial reporting is becoming continuous and that new data bases may be necessary.
- We may need to move away from general-purpose financial statements to multipurpose reporting.

Elliott suggests that we study the information needs of investors to determine what they get from financial statements and what they get from other sources and what information they actually use to make decisions. At the same time he suggests that we determine what information top management uses to make decisions and compare that with information provided from financial statements. From such studies would come measurements to recognize operating factors that have productive value such as human resource assets, innovation, productivity, and quality.

The foregoing views are not necessarily inconsistent but they do suggest a series of questions relating to the approach adopted in the development of the existing mission and agenda of the FASB:

- Is the existing mechanism appropriate to deal with specific problem areas such as pensions, OPEBs, or income taxes?
- Can the FASB deal with fundamental issues such as the move to an information era and the rising use of technology in financial reporting?
- Can the Board deal with specific issues and broader questions at the same time?
- In the light of the challenges presented by the authors, how should the FASB respond? Should its mission change? How should its agenda be set?

I look forward to an interesting discussion of these and other issues.

U.S. Accounting: A National Emergency

A background paper by Robert K. Elliott, *Partner, KPMG Peat Marwick*

Our U.S. financial accounting paradigm is important to our national[1] competitiveness, is "broke," and needs fixing. The "paradigm" involves the preparation and publication by U.S. companies of periodic, historical, cost-basis financial statements. These statements, developed for, and highly appropriate to, the bygone industrial era are not sufficient for investors to evaluate information-era companies. Worse, they discourage departing from the obsolete industrial era while our competitors (principally Japan and Germany), for whatever reasons, are not being held back. The FASB's constituents have not pressed for the changes that would rectify this situation. But unless we bring the paradigm into the information era, U.S. industry will continue to be hampered by high capital costs, nasty financial surprises in the marketplace, and deteriorating competitiveness.

Through the ages, mankind has developed three basic technologies of wealth creation: agriculture, industry, and information. (See illustration, page 14.) Each of these in turn requires a more sophisticated form of accounting information. Our accounting paradigm represents a well-developed structure for the industrial era, but it is completely inadequate for the information era.

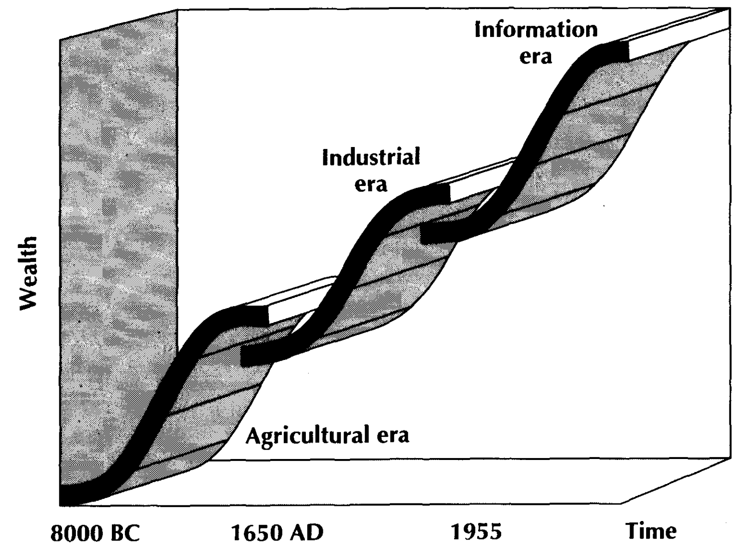
Our U.S. Accounting Paradigm Is Fundamentally Industrial

Information technology—computers, communications equipment, and their associated networks and software—is radically altering all entities. First, it permits leading companies to become more competitive by getting

The assistance of Peter Jacobson in preparing this background paper is gratefully acknowledged.

[1] This paper is national in its orientation because the FASB is a national institution. The FASB affects the welfare of U.S. citizens and America's competitiveness. If American workers and management—working for multinational or local firms—do not have accounting systems that permit them to turn out more value per unit of input than other countries, the U.S. will continue to lose economic ground.

Three Different Accounting Eras



Three fundamentally different methods of wealth creation. For each, a different form of accounting information is required.

closer to their customers, improving the quality of goods and services, providing a greater variety of product offerings to more closely meet the needs of consumers, and operating as truly global enterprises. Then, it forces lagging companies to change just to "stay in the game" with the leaders. It demands that companies emphasize not just quality, but *ever-improving* quality. It dictates that companies cut their product-design and production cycle times to get closer to consumer demands and expectations. It leads companies to focus on the creation of value for consumers, to acquire missing technologies and human assets through partnering and alliance relationships, to downsize, and to seek strategic benefits from the use of information technology.

All firms are, or are becoming, information-era companies in the sense that all products and services—and the means used to produce them—are becoming more information intensive. An automobile contains thirteen computers. An insurance policy is tailored to a specific policyholder. Training, R&D, market studies, planning, design, advertising, internal communications, and other information activities constitute an increasing proportion of the value delivered to customers.

These changes radically alter the job of management of information-era enterprises. The industrial-era manager operated within a hierarchical entity. Hierarchical entities can grow very large, but tend to be slow moving. The hierarchy ossifies into a set of functional "stovepipes"—such as marketing, engineering, manufacturing, sales, accounting and finance—that impede fast action. Even if companies try to cut through these stovepipes—by using interdisciplinary task forces—the budgetary system quickly snaps the organization back to its stovepipe thinking. As a result, U.S. automakers typically take six years to go from a product idea to a car in the showroom.

Industrial-era managers use Frederick W. Taylor's well-known time-and-motion approach to management. Those weaned on his book, *Scientific Management*, or on derivatives figure out the "optimum" way to perform manufacturing or processing tasks, and the control system of the entity is built to "lock in" the "optimum" production process. In this system, there are standard rates of productivity, standard rates of scrap, and variations from standard are systematically suppressed.

Management's job in an information-era company is much different. It attempts to organize as a network instead of as a functional hierarchy—and modern technology enables that. With no stovepipes to cut through, it can move faster. For example, Honda can get a new product idea into the showroom in three years, and is targeting for two.

Management's job is no longer focused primarily on a fixed basket of assets bequeathed to it by prior management (such as raw materials, finished goods, and plant and equipment) and the relatively fixed goals of production and distribution. Now it must focus on information assets (such as human resources, research and development, and capacity for innovation). It must also project its resources globally, make technology investments, shrink product-design and production cycles, improve quality, and determine customer satisfaction.

These managerial tasks in the information-era company are quite different, but we accountants continue to supply both management and external investors (debt and equity investors) with the same industrial-era financial statements.

We supply a statement of resources (balance sheet) and change in resources (income and cash-flow statements). Our cost-accounting models continue to enforce the Taylor model, which suppresses change—including improvement. Our very account-coding structure enforces the hierarchy: The digits in a general-ledger account-coding structure represent the levels of the hierarchy—the left digits are high in the hierarchy (say, divisional), and the right digits are low (say, specific activities on the factory floor).

We need to provide new accountability paradigms. They should measure rates of change in resources and rates of change in processes, and should focus not on target levels of activity, but on target rates of improvement in activity. They should account for the off-balance-sheet assets so vital to the information-era enterprise. Certainly, management today would benefit from measures of process activity in real time, in place of event-based measures after the fact.

Real-time measurements are a target for a number of reasons. Not too far down the road, we will have real-time financial statements. Investors will be able to tap on-line data bases with financial statements that could be updated in real time by management. The advantage this presents would be minimized if the data were strictly historical. More importantly, the frequency and freshness of measurements must be related to the speed of change in the process to be managed and its environment. No one would conceive of driving a car with a TV screen—in place of a windshield—providing hourly snapshots of where he or she was two hours ago.

Following is a comparison of the features of the industrial accounting paradigm to those of a possible (but yet undeveloped) information-era paradigm:

Industrial era	*Information era*
Measures resources	Measures rates of change in resources
Measures processes	Measures rates of change in processes
Measures tangibles	Measures intangibles
Focused inwardly on production costs	Focused outwardly on customer values
Waits for events (transactions) to occur before measuring	Measures processes in real time
Maps the hierarchy	Enables the network

Companies striving to become information-era companies are aware that their accounting systems—financial and managerial—do not provide the types of information they need to manage. Consequently, they are seeking new performance-measurement models—to identify the leading indicators, to measure them, and to connect performance to motivation and reward structures in order to motivate the degree of innovation needed to compete in the information age.

Some companies are experimenting with a "balanced scorecard" in which their accounting systems measure not only the traditional financial attributes ("How do we look to our stockholders?") but also such issues as customer satisfaction ("How do we look to our customers?"), internal processes (productivity, quality, and cycle time), and capacity for innovation (learning curves, conversion of research to salable products, etc.).

A key difference is that the financial measures do not focus on earnings per share (EPS), return on assets (ROA), or return on equity (ROE). Instead, they focus on shareholder value using concepts introduced by Alfred

Rappaport.[2] Shareholder value can show radically different results from the earlier measures. A company can have rising EPS, ROA, and ROE yet declining shareholder value!

So even the financial accountability set is rounded out to focus on producing the information that drives the shareholder value model—value growth duration, sales growth, operating profit margin, income tax rate, working capital investment, fixed capital investment, and cost of capital.

The experiments by individual companies and the concepts explained by Rappaport are evidence that there are new accounting and reporting needs. They also represent a recognition that the movement toward information-era companies, with all that it means for the relevance of the industrial-era accounting paradigm, is irreversible.

The Deficiencies in Our Accounting Paradigm Injure All Constituencies

Investors

We know all too little about the degree to which the current accounting paradigm actually serves the interests of investors. But we do know this: Their entity-specific data is not confined to what they receive in financial statements. Analysts meet with management, follow what they can about the quality of its products, its cycle times. These matters are treated as significant by the financial press. No one denies that they are relevant. Yet investors are forced to rely on data from unreliable sources. The information may be oral, unaudited, and impressionistic. It is certainly not as efficiently distributed as are financial statements.

This means that stockholders cannot fully rely on financial statements to judge stewardship. They may turn to the President's Letter, not because its news might be more cheering, but because there might be different and more illuminating information.

Consider the large differences between takeover bids and market capitalization that sometimes occur and what this means about the information investors have been getting. Obviously the prospect of new management or corporate reorganization explains much of the difference, but it is unlikely that all of the difference can be consistently explained that way. So we are left with two other possibilities: either the market has been inefficient in impounding information or it has been deprived of information. But we have a great deal of evidence indicating that the market is in fact quite efficient in absorbing information to set market prices. This suggests that

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[2] Alfred Rappaport, *Creating Shareholder Value: The New Standard for Business Performance*, New York: The Free Press, 1986.

the market has been deprived of the information to value assets properly. Perhaps it is unaware of certain assets or, if aware, not well-enough informed to make a good estimate. This is another way of saying investors have been deprived of the information, because it is investors who make the market. Such deprivation would confirm what the term *undervalued assets* has been alleging.

Management

The persistence of the industrial-era financial reporting paradigm increases the cost of capital for companies. Their cost of capital can be modeled briefly by starting with the risk-free rate of return, which is the Treasury bill rate. To that would be added a premium for economic risk and a premium for information risk. These two are related but separate. Information risk is the risk that economic risk is misperceived because of information that is incomplete, insufficiently relevant, or insufficiently reliable. The less certain the potential investor is about his or her understanding of the economic risk, the higher the information-risk premium charged. Conversely, the more certain the potential investor is about his or her understanding of the economic risk, the lower the information-risk premium charged. Today's periodic, historical, cost-basis financial statements do not provide as complete a set of relevant entity-specific data as is feasible to enable potential investors to understand the economic risk of investing.

Company representatives do meet with analysts, but this must be considered an ad hoc remedy, more a sign that there is a problem than of its satisfactory resolution. It is also an added cost to the disclosure system. In addition, such meetings give the idea of preferential treatment for the "user with clout" more meaning than it has had in the past, which is not good for confidence in the fairness of the capital markets.

The lack of a more complete set of relevant data in general-purpose financial reporting also limits communication between management and owners, whose need and right to understand changes in the economic risk of their investment is well recognized. In this way, the lack of a more complete set of relevant data undermines the spirit of management's discharge of its fiduciary responsibilities to owners.

Finally, although we do not know the full effect industrial-era public reporting has on management, there is reason to suspect it is not good. We cannot assume from the distinction between management accounting and external reporting that management has all the relevant information that would assist its decision making. An intense focus on the kind of information that might be usefully reported for an information-era enterprise should bring to light types of data that can serve management's decision making. We know that many managements are now actively seeking new performance measures. The FASB's assistance, which would be a by-product of any quest for information-era public reporting, should help improve the measures used for management purposes.

CPAs

An audit report is only as useful as the audited information. If financial statements grow less relevant, so do audits of those financial statements. This presages the obsolescence of the auditor's core product. Already there is growing evidence of price competition in the marketplace for audits. This could be a sign that audits have begun to lose their role in diminishing information risk because the audited financial statements, even when credible and reliable, are less effective in diminishing information risk.

Today CPAs and management of failed businesses are often criticized and sued over allegedly fraudulent financial statements that have received an unqualified opinion before any reasoned determination of whether the financial statements complied with generally accepted accounting principles (GAAP) has been made. In terms of the risk model we have been discussing, the critics are failing to disaggregate economic from information risk. In terms of what the public expects from the financial reporting process, the premature criticisms are consistent with the assumption that the financial statements failed the user, that whether or not reliable and properly audited, they did not serve the investors' interests. Although mere consistency with a scenario is not a firm basis for an argument, especially where suits are aimed at "deep pockets," the frequency of these events and the publicity they receive should give participants in the financial reporting process pause. Were there greater consensus that GAAP financial statements are useful, such premature accusations would probably be less frequent and would likely carry less weight prior to an acceptable determination of their truth or falsehood. The issue of compliance with GAAP would be more prominent.

Standard Setters

The FASB has lost some of the constituency support it had when it was founded, not necessarily in numbers of constituents, but clearly in their degree of enthusiasm. A defense of the FASB's franchise coupled with acceptance of its performance does not qualify as applause, and there has been vocal criticism from some constituents. Moreover, the FASB is criticized for adopting requirements that are unnecessary, too frequent, and too detailed and that fail to meet the test of providing benefits greater than costs. The relevance of the required information, which can weigh so heavily on the benefits side of the equation, should be a more central part of such debates.

In the long term, support for the FASB will depend on how it performs the second of the activities that are supposed to accomplish its mission, namely "[to] keep standards current to reflect changes in methods of doing business and changes in the economic environment." As we have seen, there have been momentous changes since the current accounting paradigm was developed, the effective transformation from an industrial-era to an information-era business world. Embracing that fact and its pertinence to the accounting model and acting on it could shift the dialogue about the FASB's performance more toward what is relevant at this juncture in the economy's evolution.

The U.S. Economy

We have already noted ways in which the current accounting paradigm holds companies back from adapting to the information-era economy. It does not provide various types of information that could improve the efficiency of capital allocation, does not minimize the information-risk factor in the cost of capital, and can lead to faulty economic decisions. Unrecognized human-resource assets, for example, can tempt management to take a short-term earnings lift by dismissing or discouraging skilled personnel, which could turn out to be expensive when shortages in skills and deficits in experience hamper future growth and profitability. Lester Thurow has noted that the U.S., where R&D is charged straight to income, alone among major competitors, has an R&D curve that rises and falls with the business cycle. This suggests that R&D that meets the definition of an asset should be recognized as an asset, rather than be automatically charged against earnings.

These kinds of things burden us in a highly competitive world economy. Our business people, for example, burdened by unnecessarily high information risk, compete against Japan, with its lower cost of capital. The comparison is valid even though it is well known that Japan's cost of capital is influenced by other factors, such as its higher savings rate. How other countries have achieved their competitive position is not at issue here. In any case, there is good reason to believe we could not find success by copying other countries even if we penetrated precisely to the causes of their success. That does not exclude learning from their experience, but it does mean that we must chart a way suitable to our own society and diminish competitive disadvantages when we identify them.

What Should Be Done?

The FASB

The FASB should devote more resources to studying the needs of investors and educating the constituencies about the information-era paradigm. This could be accomplished in part by a study that would at the same time test the argument that investors need the kind of information that the information-era paradigm would provide. The study should examine the relationships among (1) entity-specific information from general-purpose financial statements, (2) entity-specific information investors actually apply in decision making, and (3) non-entity-specific information used in decision making (for example, the course of the economy and the industry, potential new competitors). One could hypothesize that investors would be found to use entity-specific information other than that provided by GAAP, and that such information is often associated with non-entity-specific information by lumping all nonfinancial statement information together. The point of the latter test would be to determine whether investors' expectations of GAAP are limited (perhaps because they have atrophied) and need to be enlarged.

A parallel study would focus on the information top management uses to make its decisions, comparing it to what is made available through financial statements. The traditional distinctions between managerial and financial accounting should not mean that one cannot learn from the other. At the least we should be assured that whatever the differences between the two information sets, both are based on compatible assumptions about the economics of business enterprises. Moreover, top management may be using information that is different from either set.

Anecdotal evidence suggests that may be the case. For example, the CEO and founder of an extremely successful company recently told me that "trying to run my company with the output of my accounting department is like trying to fly an airplane with only one gauge, which tells me the sum of airspeed and altitude. If it's low, I'm in trouble, but I don't even know why."

Assuming these threshold studies support pursuing the information-era paradigm, the FASB should develop measurements to recognize operating factors that have predictive value. These would include, for example, human resource assets, cycle times, innovation, productivity, and quality.

These disclosures would meet the requirement implicit in the purpose of financial reporting as set out in the FASB's conceptual framework. There it is stated that "financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (Statement of Financial Accounting Concepts [FASB Concepts Statement] No. 1, paragraph 37). However, in considering requirements to disclose such measurements, and others from the information-era paradigm, the FASB would also have to evaluate the prospective costs and benefits and the balance between degrees of relevance and reliability.

In evaluating the trade-off between relevance and reliability, the Board should consider not only the relevance and reliability of the data that might be required. It should also consider whether investors are depending on less reliable sources of the same information. The comparison to historical cost may make the new information seem soft, but the comparison to what investors otherwise resort to might make it seem relatively hard. It would also throw light on investors' needs, and in the end the Board will be judged by its service to users of financial reports.

The Board set a precedent for supplementary disclosures of information less reliable than what is reported in financial statements with the issuance of *Financial Reporting and Changing Prices*, and it has generalized about it in FASB Concepts Statement No. 2: "Almost everyone agrees that criteria for formally recognizing elements in financial statements call for a minimum level or threshold of reliability of measurement that should be higher than is usually considered necessary for disclosing information outside financial statements" (paragraph 44). The Board must determine whether that lower threshold can be met.

It is hardly too soon to be asking these kinds of questions. Already the federal government is pondering whether human resource investments would be appropriately included in the capital portion of a restructured budget. The GAO report on this issue states that "in the private sector, many economists and researchers agree that some education and training programs are investments in human capital."[3] Discussions of the cost of higher education in terms of its revenue-yielding benefits to students are now commonplace, and training programs in the business world are designed to obtain "probable future economic benefits," to use the FASB's definition of an asset.

Management

Management should seek better performance measures for internal use, as some are already doing. It is clearly in their interests to have such measures for managerial purposes, and they may in time contribute to general-purpose reporting. Management could take the initiative by experiments with voluntary disclosures that fit the information-era paradigm. They would be helpful to the FASB as well as to investors, partly because they would help educate FASB constituents to the new paradigm.

Such voluntary disclosures might not be an altogether off-putting prospect to management when they are understood. The opportunity to recognize new assets, such as human-resource assets, for example, might be welcomed, demonstrating to the investment community additional strengths. To take another example, the morale of company personnel whose daily efforts are bent on improving quality and reducing cycle times might benefit from disclosures that publicly recount their success. These kinds of benefits would no doubt be weighed against the disclosures' effects on the company's competitive stance, but it is clear that the disclosures have potential benefits to management.

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[3] U.S. General Accounting Office, *Budget Issues: Human Resource Programs Warranting Consideration As Human Capital*, April 1990, GAO/AFMD-90-52, p. 1.

On this count the paradigm can be contrasted to the movement to increase disclosures of risks and uncertainties within the scope of the current accounting paradigm. These disclosures are clearly useful to investors, but they can create anxiety among management that the revelations will be interpreted negatively.

CPAs

CPAs have so much at stake in the viability and usefulness of audited presentations that it would be in their interests to promote the migration toward the information-era paradigm. Such efforts need not be restricted to lobbying the FASB or even primarily devoted to lobbying. Perhaps the best way CPAs could promote the information-era paradigm is by demonstrating that they can report on the new disclosures and can thereby provide investors with assurance as to the reliability of the measures.

There is a precedent for this kind of work, as anyone who has followed the history of forecasts and projections is well aware. Once demeaned as too soft for presentation, forecasts are now routinely presented with CPAs' reports. Moreover, the precedent should help technically. The basic concept of evaluating the reasonableness of management's assumptions may be the key to reporting on the disclosures that emerge from the information-era paradigm.

Investors

We have already assigned investors the somewhat passive role of being the subjects of study. They can do much more than that. Over the course of standard setting since the FASB began its career, investors have been in the ironic position of being both the featured constituency in the conceptual framework and the least active constituency participating in the due process that leads to formulating standards. That should end.

Participating in standard setting's due-process procedures, with their discussion memoranda, exposure drafts, and hearings, can take a good deal of time, and if that is the reason for the relative slack in investors' participation, selective intervention would be an alternative. Investors could focus their recommendations and comments on the Board's agenda and also provide feedback on the relevance of the information provided under the standards in place. In this way they could make the kind of contribution only they can make, providing hard data on investors' needs.

Of course, there may be reasons other than time that explain why investors and their representatives have not played a greater role in the FASB's work. For example, it may be that it is not considered in the self-interest of those who sell their own information on the value of securities to lobby to make information-era or other disclosures universally available and recognized as useful. If such a competitor's silence is the cause and will be a fixture, it would have long-term consequences for the way we think about the standard-setting process. It may lead to frank acceptance that investors' needs must be determined without their cooperation. In any case, a better understanding of the reasons for investors' relative silence would be helpful.

The SEC

The SEC has the power to take initiative on adapting to the information-era paradigm, and it can also influence the FASB to move in that direction. As a public-sector body it has perhaps a greater obligation to establish a defensible basis for its actions than even a quasi-public body like the FASB. It would therefore be appropriate for the Commission to research the need for adapting to the information-era paradigm itself or to urge the FASB to do so. Assuming that the research, performed by whatever body or bodies, confirms the need to move toward the information-era paradigm, the SEC should investigate safe harbor rules for presentations that serve the identified needs.

There is a precedent for SEC research on these types of issues, the Advisory Committee on Corporate Disclosure, which reported in 1977. The Committee was the SEC's initiative, its charge was very broad, and its report was well received and influential. In addition, we know that in serving investors through the disclosure system the SEC has taken steps in the past on the grounds that the present accounting paradigm has limitations, for example, the requirement for Management's Discussion and Analysis.

A New Language

Accounting has been called the language of business, but there is good reason to doubt that it alone merits that sobriquet today. When you read about modern management and business in the financial press or in periodicals or books, you find another language has taken its place beside accounting. It is the language of the information-era paradigm, used to address the current and coming problems and opportunities of business. The time has come for accounting to study that language, to select from it what elements can be effectively measured and reported, and to define how to present it uniformly.

The Rule-Making Process: A Time for Change

A background paper by William J. Ihlanfeldt, *Assistant Controller, Shell Oil Company*

Overview

Recent events are sending some signals that the corporate community's concerns may finally be getting some attention from the FASB. While that is encouraging and the changes seem to be pointing in the right direction, it may take more than mere raging incrementalism to still the legitimate criticism.

The FASB is clearly a natural target for criticism, and has been almost from the beginning. It has been criticized for issuing "cookbook" accounting standards on the one hand and for being too broadly conceptual on the other. It has been condemned for standards that are too complex and costly to implement, and accused of a preoccupation with "conceptual purity" resulting in standards that are far removed from reality. Most recently, critics have asserted that the Board does not pay enough attention to the social consequences of its actions and that it has too much autonomy.

While some of the critics are new, the criticisms are not. The labels get changed, but the underlying discontent is the same. What is new is the recent ground swell of opinion within the corporate community and the public accounting profession that changes need to be made in the standard-setting process. Also new are some of the remedies that have been suggested to accomplish this.

Some in industry have even suggested that accounting standard-setting responsibility be taken away from the private sector and turned over to the Securities and Exchange Commission, or that an oversight committee that would have veto power over projects added to the Board's project agenda be established. Others have suggested less drastic action, which they characterize as fine tuning, such as the more effective use of project task forces and

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Comments in this paper rely extensively on material appearing in "The Rule-Making Process: A Time For Change?" an article, co-authored with John C. Jacobsen, which appeared in the March/April 1989 issue of *Financial Executive*.

the need to do more field testing of the FASB's tentative conclusions on major projects.

The idea of turning accounting standard setting over to the Securities and Exchange Commission seems to have little or no support. Politicizing the standard-setting process would not be helpful. Similarly, establishing an oversight committee with the power to overrule Board project agenda decisions would erode its independence and weaken the credibility of the process. Neither solution is very good. But both are certainly symptomatic of the business community's growing perception that it is not being heard in Norwalk.

So the question is: Are these concerns justified? And, if so, how can they be addressed? Several years ago, a coalition of members of industry, including some from the Financial Executives Institute (FEI), argued that what was needed was a shift in the balance of power at the FASB, with more industry representation on the Board of Trustees of the Financial Accounting Foundation (FAF) and more practical experience in the FASB itself. Since that time, the FAF has added a fourth member from industry to its sixteen-member Board of Trustees, and the seven-member FASB now includes two members with industry backgrounds.

Those were constructive steps. But they obviously have not decreased the level of criticism and have not been successful in allaying the industry's concerns. In retrospect, it was probably unreasonable to expect that they would. While industry representatives bring an industry perspective to the Board, they are independent and objective thinkers fully capable of arriving at their own conclusions, which may or may not reflect the prevailing views of their business constituencies.

The hard fact is that there are fundamentally differing views between the standard setters and the business community on what accounting standards are supposed to do. These differences get reflected in the consideration of such things as the need for tradeoffs between conceptual primacy, complexity, and cost; whether the focus of standards should be on the income statement or the balance sheet; and enhancing the usefulness of financial information. And, of course, both sides use the same words to support their views—words such as *useful, relevant*, and *cost-effective*—but they attach different meanings to the words. These differences in perception have significantly hindered the dialogue. While the standard setters and the business community may listen to one another, there is certainly ample evidence that neither hears very well.

The key to improvement may be in a greater willingness to compromise, and by that I do not mean giving in to special interests. What I mean is give and take—listening and hearing, and then reacting to concerns in a tangible way rather than dismissing them as self-serving. The dialogue today is defensive where it needs to be constructive. Both sides must work at it, but it's time for a change.

Business Is Both a Preparer and a User

For openers, the FASB needs to accept the notion that its critics in the preparer community are not totally preoccupied with the impact accounting standards may have on their bottom line. Financial-statement preparers are also users of financial information, a reality the Board tends to heavily discount. One seldom hears a Board member mention users and preparers in the same breath. Instead, the Board seems inclined to emphasize the distinction between industry as preparers and almost everyone else as users.

The simple fact is that the same people who are preparers are probably the largest class of users of financial statements. For strategic planning purposes, for example, companies analyze the competition's 10-K to determine information on market share, costs, and a variety of ratios. They also analyze such data when considering investment possibilities, including pension funds, and when making decisions about potential mergers and acquisitions.

This dual role as both preparer and user results in a unique ability to recognize the needs of both. But the Board clearly gives little weight to this, preferring the notion that industry speaks only as preparers, that it is overly resistant to change, and that its views, however articulate (or inarticulate), are suspect. It is this bias that fuels industry's argument that "the Board won't listen."

The Board has lamented that it receives relatively few comments on its proposals from those it perceives as the principal users of financial information, namely, investors and creditors. And so it manufactures what it thinks would be useful to them, while discounting the legitimate concerns of preparers/users. One cannot help but feel that the Board is being overly influenced by what it deems to be the needs of a rather narrow slice of its constituency, and a relatively unresponsive slice at that.

In contrast to such users, industry, as both preparer and user, submits two-thirds of the comments the Board receives on its proposals. It would seem to follow, then, that the Board, in measuring how well it is fulfilling its mission of serving the needs of users of financial information, must do more than just "listen" to industry's views. It needs to be less defensive and respond to industry's views in a more positive way, not just write them off as being self-serving or as a mere expression of resistance to change. The FASB needs to keep in mind that industry also speaks as a user of financial information.

The Process Will Work

The FASB has contributed significantly toward improved financial reporting. But the current trend toward more complexity (recognizing that more complex issues are coming before the Board) dictates the need for the Board to improve its understanding of the impact of that complexity on preparers. Meaningful dialogue and a willingness to compromise toward what is practical are essential. The Board continues to have the strong support of its business constituency, but it can expect continual erosion of that support if it fails to heed the increasing chorus of disenchantment.

We don't need major reform. The process will work. What we need is a genuine effort on the part of both the business community and the FASB to listen carefully to one another, to find acceptable compromises, and for the FASB to extract the added strength that comes from a true partnership with its constituency. The Board's principal challenge is to provide the leadership that will make this process work.

Will Fine Tuning Help?

A number of recommendations have recently been made that have the potential to improve the process of standard setting: the idea of issuing a prospectus for public comment on projects the Board is considering adding to its project agenda; the suggestions that have been made on how project task forces can be more effectively used; and the idea that the Board issue for public comment its preliminary views on a project before it issues an exposure draft of a proposed standard. These are all good ideas that deserve serious consideration. The argument that such procedures would slow down the process is a red herring. What we need is more general acceptance of accounting standards, and we should take whatever time it takes to get them right.

Another recommendation, which has been around for a while, is that the Board field-test its conclusions on major projects. There is strong support for using field tests in projects that take the Board into uncharted waters, and I applaud the members for those occasions when they have done so. This practice better than others can provide the Board with valuable insights into the practical consequences of applying its conclusions on a project. For example, field-testing the Board's preliminary views on accounting for pensions, sponsored by the Financial Executives Research Foundation (FERF) (with the results published in 1983), confirmed that application of the FASB's tentative conclusions would have introduced a high degree of volatility into companies' annual pension expense, even when a given pension plan's provisions and plan population were unchanged. This resulted in the Board making changes in the final standard that helped to reduce volatility. And here, it must be said, they did listen—but it was not without considerable prodding.

More recently, a FERF field test of the Board's conclusions on accounting for postemployment benefits shed considerable light on a number of measurement, data collection, and other issues—and did so even before the Board issued its exposure draft. The final report of this field test helped the FASB and its constituency understand the merits and weaknesses of the exposure draft.

Had the Board been receptive to field-testing its conclusions on accounting for income taxes, FASB Statement No. 96 might well have turned out differently. In the past, the FASB has tended to look at field-testing as a code word for delay. That is an indefensible position given the positive evidence already available that field-testing improves the result.

Discussion Topics

> The recent past has been marked by contention approaching rancor among those outside the government who are involved in the financial reporting process. Such a state of affairs cannot continue. Either the contending forces must find common ground for cooperation or the opportunity to cooperate will be lost. We have attempted to suggest such a common ground.[1]

I suppose the above quote might well have been taken from one or more of the myriad letters written in the past year or so by those who closely follow the FASB, its mission, and its agenda. Actually, it comes from the 1972 Wheat Committee Report, which led to the establishment of the FASB. Undoubtedly, there are differing opinions about whether it even comes close to describing where we are today, but it does give us a point of departure as we examine these important subjects.

Also relevant to this discussion is the Wheat Committee Report's conclusion that

> the success of a standard-setting board in the private sector depends in the final analysis on acceptance of its standards by the business community, practicing accountants, the SEC, and the public. We are satisfied that such acceptance will be forthcoming provided:
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> 1. The standard-setting body possesses unassailable independence and objectivity in fact and in appearance.
> 2. There is significant participation by the financial reporting community in the process by which standards are set.
> 3. Standards are promulgated only after a public procedure which insures that all interested parties are heard and their views are considered.

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[1] AICPA, *Establishing Financial Accounting Standards: A Report of the Study on Establishment of Accounting Principles*, New York: March 1972, p. 83.

4. The quality of pronouncements is high—there must be persuasive logic and supporting reasoning, consistency with agreed-upon objectives, room for professional judgment in appropriate circumstances, and perceived usefulness to investors and the public.
5. The members of the accounting profession support the standards in attesting to the fairness of financial information.[2]

There isn't much question that these five criteria are as critical today as they were in 1972, and I believe there is general agreement that, except for item 4 dealing with the quality of pronouncements, they are being carried out as well as or better than the Wheat Committee could have hoped for.

Financial Reporting—Quality of FASB Pronouncements

While there is diversity of opinion on which are the most important issues facing standard setters today, certainly two important issues are how well the standard-setting process is performing in terms of promulgating cost-effective improvements in financial reporting, and what effect the globalization of markets will have on such reporting.

These issues are intimately related because both raise the question of whether current accounting standards are imposing unnecessary costs on preparers and therefore are affecting the ability of U.S. companies, particularly smaller companies, to compete internationally with foreign enterprises whose home-country accounting rules are less onerous. Indeed, after years of admonitions from U.S. industry that the FASB's accounting standards are too complex and costly, the issue of the effect of such standards on U.S. industry's competitiveness has caught the attention of the Securities and Exchange Commission. In July, the Commission launched an extensive review to determine whether there is any evidence that the Board "has lost sight of the cost side of the cost/benefit equation."

There does not seem to be much argument that accounting standards should be cost-effective. The very precepts under which the FASB conducts its activities call for "promulgating standards only when the expected benefits exceed the perceived costs." The problem is deciding what level of cost makes compliance with a standard cost-effective. The dichotomy implicit in this problem is the contention that there are two costs involved. One cost is the compliance cost incurred by preparers, and the other is the cost to users of not having the information they need to make prudent decisions. Unfortunately, there is scant quantitative data available on compliance costs, and virtually no data exists on the cost to users of not having information.

Consequently, the cost/benefit equation almost always boils down to a matter of perception, and perceptions differ. For example, preparers'

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[2] Ibid., pp. 23–24.

perceptions may be driven by the costs of compliance and the kind of information produced by a new rule, while the standard-setter's perception is driven by the perceived cost of denying such information to users.

In the absence of hard quantitative data, it is virtually impossible to assess the costs associated with implementing FASB standards. On the other hand, the pace at which new standards have been promulgated (105 since the Board's beginnings in 1973), the complexity of recent standards, and greatly expanded disclosures would suggest such costs have been high. The financial disclosures in annual reports, for example, have more than doubled over the past decade and there appears to be little relief in sight. Moreover, such disclosures have grown to a level of complexity that has caused a significant segment of the FASB's constituency to question the usefulness of information being provided to users of financial statements. A recent example is FASB Statement No. 96, *Accounting for Income Taxes*. The standard is highly complex and conceptual, raises troublesome measurement and disclosure issues, and generates substantial compliance costs.

Even though the conceptual underpinnings of this Statement were well thought out, both preparers and auditors consider the usefulness of the information to be of questionable value, and consider this a shortcoming that is a function of rigidly pursuing a conceptually pure approach to measurement at the expense of practical results. FASB Statement No. 96 was essentially rejected by the preparer community and finally, with seemingly great reluctance, the FASB decided to consider amending the standard to reduce its complexity and to take a more practical approach to the measurement of deferred tax assets.

Concepts vs. Reality. While taking a more realistic approach to the recognition and measurement of deferred tax assets requires rounding some of the square corners of the conceptual base, the trade-off of more useful information—that is, information that describes the real world—is well worth the compromise. Indeed, the pragmatic world of business suggests the relevance of pragmatic principles. The Board itself recognizes the importance of a useful result. But in the case of FASB Statement No. 96, conceptual primacy was the clear victor over usefulness. It is this tendency that sets off the rockets in the business community.

The Board's current project, "Employer's Accounting for Postretirement Benefits Other Than Pensions" (OPEB), provides the Board with an excellent opportunity to demonstrate whether the existing standard-setting framework can permit a better balancing of the conceptual and the pragmatic. More fundamental than any concern over specific issues in this project is an overall concern about the approach the Board is taking in resolving such issues. The way the Board proceeds from this point forward can be pivotal with respect to how it will be judged on carrying out its broader mission.

These are but two examples; there are others that could also be cited, where the pursuit of conceptual solutions to improvements in financial reporting has imposed substantial costs on the business community to provide information that is of questionable value. This raises the issue of whether the objectives of financial reporting envisioned by the Wheat Committee when the FASB was established are indeed being met, and whether the costs incurred by industry to comply with the FASB's rules can be justified without taking into account this country's ability to compete in the global marketplace.

A Time for Change. It is clear that something quite fundamental has to change if we are to see accounting standards that will receive general acceptance. The Board needs to find a better way to meet the precept in its mission statement to "bring about needed changes in ways that minimize disruption to the continuity of reporting practice." At least in the short term it won't be the conceptual framework that will change. What is needed is a new direction. The Board must find a way to integrate and give appropriate weight to realism and pragmatic considerations. This does not mean that conceptual considerations need to be abandoned or that the usefulness of information needs to be compromised. But it does mean a significant change for the Board, in that realism and pragmatic considerations will have to be given appropriate weight, so that such considerations will influence the decision-making scales just as surely as conceptual considerations do at present.

This vision and hope for a significant change in the way the Board approaches projects will not come easily, because it is not only the Board's constituencies that have a natural tendency to resist change. I firmly believe that if the Board were to take a fresh approach during the final phases of the OPEB project, it would score a major victory with its constituencies. I would like nothing more than to hear from other interested parties that the Board's approach to this blockbuster project was quite different from its approach to past projects and that the final standard is quite reasonable in the circumstances. This kind of result could signal a new direction for the Board.

Regrettably, I do not believe this will be the outcome, except possibly for transition, where the Board often makes decisions on pragmatic grounds. I see little evidence, even though there may be a compelling case made on a particular issue, that the Board could be comfortable with an answer that is not totally defensible on conceptual grounds. By any measure, the Board will have made dramatic strides in bringing OPEB accounting to an accrual basis, but it seems unlikely that the Board will settle for climbing Pikes Peak when its vision of the conceptual framework would have it conquer Mt. Everest on the first climb.

Why does the Board feel so hesitant to step from behind the fortress of conceptual primacy, when to do so can simplify implementation with no measurable reduction in usefulness? The individual members of the Board are among the best accounting minds we have. To venture now and then from behind the breastworks won't result in the destruction of the fort. The strength of the Board can only be enhanced by the occasional intervention of common sense into the notion of conceptual primacy.

The FASB: Its Mission and Agenda

The Wheat Committee Report also addressed the role that financial executives of corporations should play in the standard-setting process:

> Many well-informed persons believe that financial executives of corporations should play no part in standard setting. One member of the APB has put it to us that there is an inherent conflict between their role as managers and the task of measuring their own performance. An analogy might be having the baseball batter calling balls and strikes.
>
> . . .we think the Board member quoted above invokes the wrong analogy, since the role of the Board is not that of enforcing standards, but of developing them. True, the baseball batter should not call the balls and strikes; but there is no reason why he should not have some say in developing the rules of the game.[3]

These comments relate specifically to the question of whether financial executives should be eligible to become members of the FASB. The Wheat Committee Report makes it clear that broad participation in the entire standard-setting process is essential if there is to be general acceptance of the Board's standards.

One of the steps that can be taken to stem erosion of support for the FASB, particularly in the preparer community, is the Financial Accounting Foundation's making absolutely certain that persons appointed to the Board, irrespective of their professional background, fully support the notion that each element of the Board's constituency has a fundamental right to fully participate in every aspect of the Board's due process system. The preparer community already has a built-in problem in demonstrating objectivity in urging the Board to adopt its suggestions on financial reporting issues; it would be patently unfair to have these suggestions rejected by a Board member solely because of a belief that the preparer community has no business "developing the rules of the game." More specifically, I reject the view advanced by some that the role of preparers should be limited to commenting on implementation issues and problems associated with proposed standards, and that comment on the substance of proposed standards should be left to others.

Neutrality in Standard Setting. As part of any discussion of cost/benefit considerations, one must also consider the issue of neutrality in standard setting.

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[3] Ibid., p. 60.

The rules under which the FASB operates call for the Board to be objective in its decision making and to ensure the neutrality of information emanating from its standards. Neutral information as set forth by the FASB's precepts is information that "reports economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction." In applying this principle, Dennis Beresford, chairman of the FASB, has been quoted as saying, "Financial accounting standards must not be designed intentionally to provide an advantage for one company over another, one industry over another, or even one nation's industries over another. Financial statements are not meant to be propaganda."

It is difficult to imagine anyone arguing that financial statements should not be objective and faithfully represent economic activity. After all, this is what accounting is supposed to be all about. Mr. Beresford's interpretation of the notion of neutrality in standard setting, however, would seem to suggest that those who argue for more pragmatic and cost-effective accounting standards are merely seeking favored treatment and have lost sight of the fact that financial statements should be objective.

If subscribing to neutrality means that we cannot produce practical and straightforward accounting standards that are cost effective and yield understandable results, perhaps the way the Board applies this precept needs to be revisited. In doing so, it needs to be understood that the business community has a legitimate role in the standard-setting process, and that its interests are not opposite those of the standard setters. Rather, it is more a question of tempering ideals with the realities of the competitive world in which we live, and determining an appropriate balance between that world and the FASB's mission.

The FASB's Future Agenda. The Board's present agenda is more than adequate to keep it fully occupied for the foreseeable future. Several current projects, such as "Impairment of Long-Lived Assets and Identifiable Intangibles" and "Interest Methods of Accounting," could result in major changes to the current accounting model.

However, the most dramatic changes are likely to come from the "Financial Instruments and Off-Balance-Sheet Financing Issues" project that was added to the Board's agenda in May 1986 as a direct result of a request from the SEC. The Board's current schedule calls for work on both the disclosure and the recognition and measurement phases of the project. However, it remains to be seen whether or how the Board's priorities will change as a result of recent expressions of concern by the SEC that current accounting standards may be imposing unnecessary costs on U.S. companies and, of even more concern, that there is a possibility of sweeping changes in the way financial assets are carried in the financial statements.

The Coming Deregulation of Accounting Principles

A background paper by Gerald I. White, *President, Grace & White, Inc.*

I am pleased to participate in this symposium on financial reporting and standard setting. When I was first asked to present a paper, I expected that this would be a typical low-key discussion of the role of the Financial Accounting Standards Board (FASB). We would all agree that the Board had faults but was, on balance, performing well.

In the last few months, however, there has been a decided change in the climate of discussion about the FASB. Criticism has been forthcoming from such diverse sources as the Business Roundtable, the Securities and Exchange Commission (SEC), the AICPA, and the Financial Accounting Foundation trustees. Some of this criticism has been indirect rather than clearly stated, but it is nonetheless real.

Before elaborating on the rather provocative title of this paper, I would like to address the topics in the stated agenda for this symposium.

Financial Reporting: Why Is It Needed?

Our starting point is, necessarily, why the need for financial reporting? While it seems to me self-evident that it is for external users of financial statements, a different view has been circulating recently. At a luncheon sponsored by the Financial Executives Institute, Colby Chandler, then CEO of Eastman Kodak, said that "businesses are not only the primary preparers of financial reports, we also are the primary users."

I find this view of financial reporting to be, at best, disingenuous. Clearly, preparers are users of financial information, and very privileged ones at that. They have the ability to generate whatever financial and other data they require in whatever form they wish to have it. They do not need the FASB, the SEC, the AICPA, or any other body to obtain the information they desire.

The external user, in contrast, is the beggar at the feast, dependent on whatever crumbs of information are made available. It is investors, creditors, customers, suppliers, employees, and other external users who require financial statements in order to make economic decisions and who lack the ability to obtain the data they require. It is these users who rely on the FASB and the SEC to establish accounting and disclosure standards that provide adequate information.

Issuers as users, experience tells us, must also rely on external bodies to obtain the information needed to properly make decisions. Too many studies indicate that managers pay more attention to events that receive accounting recognition than to those that do not. FASB standards on accounting for foreign operations and on accounting for pension plans apparently increased top management's attention to these important areas. As astonishing as it may appear, many large companies apparently promised substantial retiree health benefits over decades with little idea as to the true cost of these obligations.

Financial Reporting and Financial Markets

As an investment manager, I am naturally most concerned with the use of financial information to make investment decisions. I believe that the efficiency of our financial markets derives from and depends on the timely disclosure of financial data. Market efficiency does *not* require that *all* users use *all* available information. Efficiency does not mean lack of volatility. Unexpected events, economic or political, may radically change market expectations and, hence, market prices. We were most recently reminded of this following the invasion of Kuwait in early August.

I believe that efficient capital markets require only that relevant information be used by *some* participants. The academic literature tells us that market prices respond quickly and rationally to accounting data. Prices are usually determined by the marginal buyer and the marginal seller. Thus, the fact that those who invest in options, index funds, futures, and so forth pay no attention to financial statements does *not* mean that markets can function without good financial reporting.

The increasing use of data bases to make financial decisions has been cited by some as another argument against the need for accounting and disclosure standards. I believe that the opposite is correct. If more people rely on reported earnings and balance sheet data, doesn't that mean that more effort should be made to ensure that such data accurately portray economic reality? Disclosure of off-balance-sheet obligations may satisfy the fundamental analyst, but some market participants (especially, data base users) will be fooled. This can hardly enhance the efficiency of the market.

Global Markets

Another argument recently used against high standards of accounting and disclosure has been the globalization of the marketplace. It has been suggested that American companies are handicapped because they must compete with foreign companies subject to less rigorous standards.

While this may be an issue for stock exchanges seeking listings, I see little relevance to the subject at hand. Despite the "onerous" standards in this country, many issuers are anxious to enter our capital markets. Even Japanese companies have been eager to tap our markets despite Japan's capital surplus. The Japanese have even agreed to those "evils of FASBdom"—segment reporting and the reporting of consolidated results. Turning to European companies, I note that Royal Dutch has an active financial relations program in this country and that their quarterly earnings releases (another "evil") contain detail far beyond British, Dutch, or International Accounting Standards Committee (IASC) requirements.

I do not mean to suggest that international standards are undesirable. I applaud the fact that the IASC has come to life. Judging by recent actions, starting with ED 32 on comparability, it appears that the IASC is changing from a "me too" body to one that is ready to challenge the FASB for leadership. Despite the lack of an enforcement mechanism, the IASC appears to be willing to take controversial stands in the interests of improving world accounting and disclosure.

Standards Overload

An additional concern often expressed about current accounting and disclosure standards is that there are too many of them. I agree. But I do not believe in shooting the messenger, either. Accounting and disclosure standards are increasingly complex because business is increasingly complex. The current FASB project on financial instruments, for example, would not have been necessary (or possible) ten years ago. The "rocket scientists" who invent complex instruments have been working overtime; accounting and disclosure have been left behind.

Similarly, a project on postemployment medical benefits would have been unthinkable ten years ago. Such a standard would have been immaterial to all but a handful of major companies. Thanks to the escalation of medical costs in recent years, such a project is now material to a large number of financial statement issuers.

Interim Reporting

Before moving on to the role of the FASB, I would like to make some comments on interim reporting. Much has been written in recent years about the evils of "short-termism" and its impact on management behavior. I agree that there is too much emphasis on quarterly earnings reports; it sometimes amazes me that otherwise intelligent people make decisions based on insignificant deviations from expected earnings. But let's make sure that the cure isn't worse than the disease.

While securities analysts deserve some of the blame for the overemphasis on quarterly results, they do not deserve it all. Too many companies have explicitly or implicitly promised consistent quarterly earnings gains; in return, they have obtained premium price-earnings ratios. The need to achieve target earnings may result in inefficient management practices; in extreme cases it can result in accounting manipulation or even fraud.

However I believe that our system of continuous disclosure helps make markets efficient. Annual earnings reports have been shown to have a limited effect on market prices; three quarterly earnings reports have taken out much of the surprise element. Reduced frequency of reporting would be likely to increase the volatility of securities prices around the time of earnings reports. Reduced frequency of reporting would also increase the opportunity for trading on privileged information. Such trading erodes the integrity of the marketplace.

Summing up, I believe that the case for strong mandated accounting and disclosure standards is as strong as it has ever been. The only real issue is who will set the standards.

The Role of the FASB

The second issue before us at this symposium is the role of the Financial Accounting Standards Board. The FASB has come under increasing criticism from the business community over the past few years. Before examining its role and the complaints of its critics, it might be worthwhile to examine the conditions which gave rise to the FASB's existence.

The Accounting Principles Board (APB), the FASB's immediate predecessor as standard setter, was a part-time committee of the AICPA. Members of the APB, primarily auditors and preparers, retained their affiliations while serving on this committee. As a result, there was much criticism to the effect that the APB was not independent of the accounting profession. Several congressional committees, notably those chaired by Senator Metcalf and Congressman Moss, charged that this lack of independence made the APB unacceptable as a standard setter.

As a result of this controversy, a committee was appointed, under the leadership of former SEC Commissioner Frank Wheat, to examine how best to establish accounting standards. The result was the establishment of the FASB. With minor modifications, the structure created at that time (the FASB commenced work July 1, 1973) has remained unchanged.

Standards by Consensus

One of the complaints about the Accounting Principles Board was that it set standards by consensus. Because of its composition, it was charged, the

APB was unable to break new ground. The FASB was explicitly made independent so that it could create new standards where none existed rather than being restricted to the codification of existing practice.

That the FASB has certainly done. It has dealt with such issues as foreign-currency translation, changing prices, leases, and (very soon) non-pension postemployment benefits, for which no standards previously existed. It has radically changed the accounting for pensions, income taxes, and research and development. It has mandated a new Statement of Cash Flows. Among current projects, those on financial instruments and consolidation promise to have significant impact on financial reporting.

The Board's willingness to break new ground has earned it much criticism, unfairly in my view. It is hard to see how the Board could have dealt with foreign-currency translation or postemployment benefits on the basis of consensus. Prior to FASB Statement No. 8 (on foreign currency translation), practice was highly variable. In the area of postemployment medical benefits, the "consensus" practice was clearly wrong. The fact that the Board was able to adopt many of its most far-reaching standards by super-majority votes (the vote on Statement No. 8 was 6 to 1) suggests that there was clear recognition that existing practice was not acceptable.

Theoretical Purity

Perhaps, some critics continue, the problem is that the Board is constrained by its "ivory tower" visions of ideal accounting rather than being willing to establish standards that deal with real business conditions.

While I am not an accountant, I think I know an accounting theory when I see one. Whatever criticisms one makes of the Board, theoretical purity is one of the hardest to support. Of its major standards, only FASB Statement No. 8, in my opinion, can be characterized in this way. Statement No. 8 was theoretically elegant and I think it was good accounting. But many preparers, auditors, and users complained about the income statement volatility under the standard. That the Board was willing to amend the standard so promptly suggests, I believe, a willingness to sacrifice good theory for preferred practice.

FASB Statement No. 52, which replaced Statement No. 8, broke one of the hallowed precepts of accounting theory: clean surplus. Statement No. 52 also, in my opinion, refutes those who accuse the Board of ignoring foreign standard setters. The final form of Statement No. 52 owes much to the similar standards being prepared at the same time by standard setters in other countries.

FASB Statement No. 33 (on changing prices) is another refutation of the suggestion that the Board is a prisoner of accounting theory. Statement No. 33 was a failure, I believe, precisely because it had no theoretical framework but was an attempt to combine two divergent views of how to adjust financial statements for price changes.

Turning to a more recent standard, FASB Statement No. 87 (on pensions) is riddled with "practical" provisions that lack any theoretical basis. I believe that Statement No. 87 is a good standard *only* because the disclosure provisions permit users to look through the accounting and analyze the plan assets and liabilities.

Standards Overload

One of the frequently voiced criticisms of the FASB is that there are too many standards. Both the cost of implementation and the cost of assimilating new information are a concern to many. As a financial analyst I do find it costly (in terms of time) to adjust to a new standard. When a new standard is not an improvement (FASB Statement No. 96 on income taxes may be one example) it is difficult to justify that cost.

For the most part, however, I believe this criticism of the Board is misplaced. As I have already discussed, I believe that the basic problem is that the pace of business change has accelerated. If companies stopped inventing new types of transactions (some of them designed to *circumvent* existing accounting standards), then the Emerging Issues Task Force and the FASB would have less work to do.

Neutrality of Standards

Recently, the Business Roundtable and other critics of the Board have raised another concern—that accounting and disclosure standards harm American companies and place them at a competitive disadvantage. While I have difficulty keeping a straight face when discussing this issue, I feel obliged to comment on it.

American companies have been "crying wolf" on this issue for many years. On issue after issue, major companies have testified at FASB hearings that a proposed standard will destroy their business, limit their access to the capital markets, or cause other havoc. Somehow these dire predictions never come to pass. In the case of FASB Statement No. 87 (on pensions), for example, a major corporate critic of the proposed standard was quoted (after its adoption) to the effect that it really wasn't so bad after all.

I know of no evidence that any accounting or disclosure standard has harmed American business. I assume that attempts have been made to document this harm but we have never been provided with such documentation. The same people who demand cost-benefit analysis would have us accept such serious charges without any proof whatever.

In order to be effective, accounting standards must be neutral. Once they are designed to achieve a particular goal or serve a special interest, they will become part of the political process. I believe that accounting standards set by a political body will serve the interests of neither preparers, nor auditors, nor users. Accounting standards must "tell it like it is" to be of any use to anyone.

What Is Wrong With the FASB?

Having spent so much effort defending the FASB from its critics, I do not want to leave the impression that I believe it to be without flaws. My criticisms, however, are somewhat different from those that grace the pages of the financial press.

One of my major concerns is the lack of an effective conceptual framework. The effort to develop such a framework is one of the Board's conspicuous failures. In the absence of an effective framework, the FASB must "reinvent the wheel" with each standard instead of drawing on a core of principles to guide it to a set of consistent standards. For example, completion of a concepts statement on the subject of comprehensive income would, I believe, make it easier for the Board to deal with the valuation adjustments and unrecognized items that seem indispensable to modern accounting standards.

The lack of a framework contributes to another major problem: the inefficient operation of the Board. The time it takes for the Board to complete a project is rivaled, in my experience, only by the time it takes New York City to renovate a building. The project on pensions and other postemployment benefits, for example, is now coming to a close after fifteen years. One of the reasons, I suspect, why the AICPA is no longer willing to submit audit guides and other documents for Board clearance is that it has tired of the endless delays in receiving such approval.

I have served on numerous FASB task forces as well as the Financial Accounting Standards Advisory Council. Despite the large number of outsiders involved in the process (or perhaps because of it), the Board and its staff seem unable to assimilate external contributions. In more than one case, a near-unanimous task force consensus has been ignored, to the ultimate detriment of the project.

The Board, at times, seems to be bogged down in due process. Whenever I read a report on the number of meetings, conferences, and similar functions that Board members and staff attend, I wonder how they get anything done. While I recognize the importance of receiving input from constituents, the Board members and staff must also have time to set standards.

Recent developments, unfortunately, seem likely to make the situation worse. The new Foundation Oversight Committee appears to be designed to soak up even more Board time in unproductive meetings and reports. If the goal is to slow down the FASB, it appears likely to succeed. The new super-majority voting provision, while not likely to affect the major provisions of new standards, is likely to waste much Board and staff time on minor issues.

What the Board needs, in my opinion, is two things. One is strong support from the Foundation and the sponsoring organizations. The second is strong internal leadership and a new emphasis on productivity. Without both, the FASB will weaken further over time.

The Age of Deregulation

The attacks on the FASB, from a historical perspective, are long overdue. The election of 1980 ushered in a presidential administration whose stated goal was deregulation. Many industries were subjected to this regimen, in some cases successfully. In other cases, notably our banking system, the result has been disastrous.

Somehow the accounting and disclosure system escaped the deregulatory process. It is true that the Securities and Exchange Commission lost interest in investor protection early in the 1980s. Perhaps the fact that so few commissioners had any interest in accounting and disclosure protected the current system from dismantlement. Perhaps the lack of any serious complaints about the current system precluded change.

It appears that the SEC's lack of interest in accounting and disclosure has come to an end. On the one hand, accountants and auditors are being blamed for the savings and loan fiasco, and there are calls for new accounting standards for the banking industry. On the other hand, American business is complaining about the burden of current accounting and disclosure requirements. That these two factors push in opposite directions has apparently escaped the notice of most observers.

The support of the SEC is, of course, critical to the continued functioning of the FASB. As the Commission has the statutory responsibility to establish accounting and disclosure standards for public companies, the Board's authority requires that the SEC continue to delegate that responsibility to the Board.

The AICPA's support is also extremely important to the FASB. The Institute recognizes FASB standards as authoritative, thereby binding auditors to their use. Thus friction between the AICPA and the Board is potentially threatening to the status of Board pronouncements.

There is another factor at work here, namely, the International Accounting Standards Committee. While the IASC has, in the past, lagged well behind national standard setters, it is now moving to the forefront. The new IASC chairman, former Board member Arthur Wyatt, is likely to accelerate that process if possible.

But IASC standards currently lack teeth because there is no enforcement mechanism. However the International Organization of Securities Commissions (IOSCO) appears to be encouraging the IASC, and the constituent bodies of IOSCO could provide an enforcement mechanism in the future.

Whither the FASB?

Apart from the current situation, the obvious concern is what will happen over the next few years. Despite more than twenty years on Wall Street, I will ignore the time-honored admonition against making forecasts—especially about the future.

A highly probable outcome of current trends, in my opinion, is that the authority of the FASB will be diminished. The current pressures on the Board and threats to its future independence have already deprived the FASB of several members whose presence will be missed. I fear that the Board will be caught in a negative spiral in which reduced authority and reduced effectiveness will feed on each other.

Related to the downgrading of the FASB would be the emergence of alternative sources of generally accepted accounting principles (GAAP). The IASC and the AICPA are the obvious providers of this product. It is also possible that the SEC, which has not taken any initiative in this area since the ill-fated attempt to develop a new accounting standard for natural resource companies in the late 1970s, will once again take a more active role. Congressional pressure to remedy perceived shortcomings in GAAP (for example, with respect to financial institutions) could encourage the Commission to act.

Brave New World?

These trends, coupled with a continuation of the deregulation mode in Washington, would create a world of deregulated accounting principles. Preparers, who are now sometimes accused of "opinion shopping," would be able to "principles shop" as well. This situation might well please those businesses that complain that GAAP does not allow for sufficient exercise of management judgment.

I believe that such a world would serve few people well. Auditors, whose image has already been tarnished by a large number of audit failures, would find themselves unable to resist the minority of preparers who seek out the most aggressive accounting principles. The result would be more failures, more litigation, and further reduction in respect for auditors.

Most users would also suffer. Perhaps the only exceptions would be those analysts and other users with the skills to deal with the proliferation of accounting principles and the resulting decrease in comparability and consistency. They would have a competitive edge as a result.

However, most users would be losers. The added cost and complexity of analysis would render decisions more difficult and expensive to make. Less sophisticated users (e.g., individual investors) and those who rely on data bases would be more easily fooled by accounting choices that fail to properly reflect economic reality.

The credibility of financial reporting would suffer. The result would be higher capital costs as investors and creditors demand higher returns to adjust for higher analysis costs and greater risks.

The Effects on Business

These effects would, ultimately, have a negative impact on preparers as well. Ironically, the more freedom preparers have to employ "management judgment," the greater the ultimate negative impact will be. Business, especially big business, is not universally loved in this country (or around the world). More investment disasters would undoubtedly result in political pressures for reform.

The higher cost of capital would also hurt business directly. At the same time that foreign issuers are obtaining lower capital costs by providing the financial markets with more information, American companies will be facing higher costs. This could hardly help U.S. business compete in post-1992 Europe or anywhere else.

Ultimately, I believe, there would be calls for a new standard-setting mechanism to once again create a single GAAP. The new mechanism could be in either the private sector or the government sector; the consequences of a government-sector body should give pause to those who believe that politics and accounting don't mix well.

The moral should be clear. I believe that an effective Financial Accounting Standards Board is an important element in the health of our financial markets. Those who seek to undermine the Board would do well to consider the ultimate price of success.

Setting Financial Accounting Standards for the Twenty-First Century

A background paper by the University of Southern California Financial Accounting Study Group (Doyle Z. Williams, *Chairman*)

Introduction

This paper was prepared for the purpose of facilitating discussion at the Symposium on Financial Reporting and Standard Setting sponsored by the American Institute of Certified Public Accountants.

The authors of the paper believe that the changing environment necessitates a thorough reexamination of financial accounting standard-setting processes in the United States. The following observations underlie the propositions offered in the paper:

- The increasing demand for and availability of alternative information is decreasing the demand for traditional financial accounting information.
- The conventional historical-cost-based accounting model is becoming increasingly inadequate for decision-support purposes.
- Users are demanding more timely, relevant, future-oriented data to assist in more effective asset evaluation and risk assessment.
- The U.S. government will become a more important user of accounting information as it relies more heavily on the accounting profession as part of the regulatory process.
- The emergence of the technology-driven information age will challenge the conventional public reporting process, enabling data to be accessed on a user-specific basis.

The USC Financial Accounting Study Group, SEC and Financial Reporting Institute, School of Accounting, University of Southern California, comprised the following members of the faculty: Walter G. Blacconiere, Paul Caster, Charles Chi, Mark DeFond, Dan Elnathan, William W. Holder, E. John Larsen, Daniel E. O'Leary, S.E.C. Purvis, William R. Smith, and Doyle Z. Williams, *Chairman*.

- Globalization of capital markets requires the United States to take a leadership role in setting international accounting standards.
- It is as important today as it was when the FASB was established that there be one independent standard-setting body for financial accounting in the United States.
- The primacy of the interests of users of public financial reporting suggests that users should play a more dominant role in the standard-setting process.
- The process that governs the deletion of items from the FASB agenda is as important to consider as that which governs the addition of items.
- Providing long-term financial resources for setting accounting standards is an important consideration if the viability and integrity of the process is to be maintained.

The constraints of a paper of this nature do not permit an exploration of all the relevant issues. Therefore, the authors have addressed only those issues they believe to be the most pressing and in need of immediate attention. Of course, those selected for attention are, of necessity, described only briefly.

The presentation of the issues may be viewed as provocative by some readers. However, agreement with the specific propositions offered is not central to the purpose of the paper. If raising these issues leads to a more thorough exploration of the standard-setting process, the paper will have served its purpose.

As faculty members in the School of Accounting at the University of Southern California who believe in the importance of retaining a viable accounting standard-setting process in the private sector, the authors hope this paper will initiate a dialogue that will contribute to that end.

Financial Reporting and Standard-Setting Process at a Crossroads

As we enter the last decade of this millennium and prepare for the twenty-first century, we find financial reporting and the attendant standard-setting process at a crossroads. Continuing on the present course, we believe, will lead to the growing irrelevance of conventional financial reporting in the new age of information. To be responsive in an increasingly competitive market for information, the changing market for financial accounting information and the regulatory processes governing the provision of such information must be carefully examined. The first part of this paper considers the changing financial reporting environment. The second part examines the process for setting standards in this new environment.

The Changing Reporting Environment

Financial reporting must be responsive to four fundamental issues to continue to serve a viable function: (1) the growing irrelevance of the conventional accounting model, (2) the role of conceptual constructs versus practical considerations in rule-making, (3) the impact of technology, and (4) the importance of global financial markets. Although several of these issues are closely intertwined, each one must be considered carefully to understand its unique implications.

The Need for a New Accounting Model

The conventional accounting model is becoming increasingly irrelevant for financial markets. The notions of historical costs and general-purpose financial statements are failing to fulfill users' needs.

Historical-cost accounting has its roots in the need to report on management's stewardship over an entity's resources. Stewardship is becoming a diminishing force in the corporate reporting environment as entities continue to expand and billions of dollars from non-equity financing sources are both on and off corporate balance sheets.

Increasingly, the U.S. government has become a major stakeholder in the use of financial information. It has begun to focus on the quality and relevance of publicly reported financial information. Regulators and legislators have asked, for example, how a firm can report to the public and regulators that it is solvent and has been recently profitable, yet file for bankruptcy in a matter of weeks.

The focus must shift from reporting on the past to a model that seeks to address prospective events. The primary interests of investors, creditors, and regulators lie not in stewardship but rather in such matters as liquidity, cash flow, return on investment, and (as taxpayers have become painfully aware in the savings and loan bailout) the market value of assets, including related collateral such as real property, that serve as security for many loans and investments.

Users of financial statements are more interested in information that is helpful in evaluating future risks than in a report of the company's past performance. Because of the rapidity of change, a firm's financial history is now less relevant in evaluating its future than it was formerly. Therefore, we offer the following proposition to guide the development of a new accounting model.

PROPOSITION 1

> To better serve the needs of users of financial statements in the emerging financial environment, financial reporting should shift its

> focus from a stewardship emphasis to an asset-valuation and risk-assessment emphasis with greater attention to prospective information.

There are several possible implications of this shift in focus, including the following:

- Greater emphasis on current costs
- Greater recognition of changing price levels
- More emphasis on the relevance of information to risk assessment
- Greater subjectivity in the financial reporting process
- Less standardization in financial reporting

If accountants do not shift from providing retrospective information to providing prospective information, their role may continue to diminish, and they may be replaced by others who are more responsive to users' needs.

The Role of Conceptual Constructs

A major issue in promulgating financial reporting standards is the role of conceptual constructs. This issue brings into play the following questions: (1) where should the emphasis be on theoretical versus practical considerations and (2) how should recognition and measurement be addressed?

Theoretical versus Practical Considerations. One of the primary objectives of the FASB's conceptual framework project was to provide a theoretical basis for developing future financial accounting standards. By issuing Statements of Financial Accounting Concepts (FASB Concepts Statements) Nos. 1 through 6, the Board implicitly, if not explicitly, took a position of establishing standards based on conceptual soundness. The result has been the gradual replacement of *generally accepted* accounting principles with *promulgated* accounting principles.

Promulgated rules would not be controversial if they *became* generally accepted, but that often has not been the case. Some preparers of financial statements have been especially critical of the FASB for being overly theoretical. Concern is often expressed about insensitivity to the practical issues involved in implementing new standards. Furthermore, the Business Roundtable surveyed its active members in 1988 and found that over 90 percent were of the opinion that the FASB was too conceptual in its approach.[1]

The underlying cause of the concerns raised by the Business Roundtable

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[1] For further discussion of theoretical versus practical considerations in setting FASB standards, see A. Wyatt, "Accounting Standards: Conceptual or Political?" *Accounting Horizons*, September 1990, pp. 83–88.

(and others) may not be the FASB's preference for theoretical over practical considerations. Instead, the problem may stem from the nature of "theory" in a social science such as accounting, and from problems inherent in the conceptual framework itself.

Social science "theory" consists of man-made rules. As such, the rules are subject to change as the composition of the rule-making body changes. This creates the potential for inconsistencies in rules over time. Furthermore, because the rules are man-made instead of occurring naturally, the likelihood of a lack of consensus and, therefore, lack of support for them increases. Evidence is found within the FASB itself—many of its statements were passed by mere 4 to 3 margins.[2]

Lease accounting rules illustrate some of the problems discussed above. For years, accounting for leases has been considered one of the most complex, theoretical, and troublesome of the topics addressed by the FASB.[3] When a lease is in essence a "financed purchase" of property, the property and related lease obligation should be recognized as an asset and a liability, respectively. Although the concept is straightforward, the rules for implementation are problematic. For example, "theory" did not determine the percentages used for the economic-life test or the cash-payments test of FASB Statement of Financial Accounting Standards (FASB Statement) No. 13. Furthermore, the FASB has issued six Interpretations and eight Technical Bulletins affecting lease accounting since the issuance of FASB Statement No. 13, and eleven subsequent Statements amend or otherwise affect the basic rules contained in this Statement.

Lease accounting rules are so complex that, when FASB Statement No. 91 was issued, amending the treatment of initial direct costs in direct financing leases, the prescribed treatment contained an error, with the result that initial direct costs would not be amortized over the term of the lease. The error was subsequently corrected more than a year later with the issue of FASB Statement No. 98.

Since accounting is a social and not a natural science, it is inevitable that written rules will not anticipate every potential circumstance or behavior. Further, specific circumstances often vary significantly, leading to unintended outcomes in the application of inflexible rules. Instead of a detailed, rule-oriented approach to standard setting, we believe the cause of financial reporting would be better served through issuance of statements of general objectives. Accordingly, we offer the following proposition.

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[2] Similar points were raised by Paul B. W. Miller in "The Conceptual Framework: Myths and Realities," *Journal of Accountancy* 159, March 1985, pp. 62–64. It should also be noted that a minimum of five votes is now required to issue a statement, demonstrating the behavioral nature of standard setting.

[3] It is interesting to note that recent pronouncements on pension accounting, accounting for deferred taxes, and proposed rules for accounting for postretirement benefits make the lease accounting rules seem easy by comparison.

PROPOSITION 2

> Statements of the Financial Accounting Standards Board should address general objectives and not prescribe detailed rules.

We recognize that regulators have a need for specific rules as an aid to enforcement. We also recognize that standards that permit interpretation in their application place an increased burden on those who attest to financial statements. Nonetheless, we believe such an approach, if applied with integrity and at a consistently high level of quality, would benefit users.

Recognition and Measurement. Critical to any conceptual framework is a meaningful recognition and measurement system. Yet the FASB's conceptual framework provides no such system.

FASB Concepts Statements Nos. 1 through 4, although well constructed, have no meaning unless issues of recognition and measurement are addressed. FASB Concepts Statement No. 5 was awaited with great anticipation and expectation that it would complete the conceptual framework by providing a definitive recognition and measurement system. Instead, the Statement offered the following (in paragraph 2):

> The recognition criteria and guidance in this Statement are generally consistent with current practice and do not imply any radical change. Nor do they foreclose the possibility of future changes in practice. The Board intends future change to occur in the gradual, evolutionary way that has characterized past changes.

The conceptual framework was conceived to guide the FASB in developing future standards; however, FASB Concepts Statement No. 5 states that accounting is evolutionary and "further development of recognition, measurement, and display matters will occur as concepts are applied at the standards level." The logic seems convoluted, at best, when concepts that are to guide the development of standards will themselves be developed from the standards. Such reasoning calls into question the rationale for the conceptual framework in the first place. To capitalize on the work of FASB Concepts Statements Nos. 1 through 4 and to place standard setting back on its proper path, we recommend the following.

PROPOSITION 3

> FASB Concepts Statement No. 5 should be replaced with a new statement that clearly establishes a sound recognition and measurement system with the potential for guiding the development of standards that will more effectively serve the needs of users of financial statements.

From the investor's perspective, accounting concepts should strive to reflect economic reality. Efficient market research in accounting and finance suggests that all available information is speedily impounded in security prices. Ball and Brown concluded that more than 85 percent of the information in annual reports has been impounded in stock prices before the reports are released, and suggested that annual financial statements do not rank high as a timely medium for investment decisions.[4]

Since the efficiency of capital markets is determined by the adequacy of their data sources, it is reasonable to expect investors to use other, more timely sources of information.[5] Therefore, the role of accounting information needs to be clarified in an efficient market where other sources of information are available.

Ingberman and Sorter[6] suggest that, since financial statements cannot compete with other sources of information based on timing, they should be prepared to assist investors to confirm and validate other, more timely information in forming expectations of future cash flows. Their position is consistent with research findings that the stock market reacts only to unexpected portions of earnings that were not captured by other information.

The competition from other, more timely information does not obviate the importance of annual financial statements; however, it has important consequences for financial reporting standard setting. Financial reporting standards that reflect asset valuation and future cash flows should be among the paramount concerns for standard-setting authorities if accounting information is to validate all other available information in an efficient market.

Impact of Technology

Changing technology is having a profound impact on how information is captured, summarized, and communicated. Technology makes information available in "real time" modes and permits customizing of data for specific uses. Emerging technology calls for a reexamination of the appropriateness of the FASB's stated objectives of financial reporting.

The FASB has determined that the primary objective of financial reporting is to "provide information that is useful to present and potential investors

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4 R. Ball and P. Brown, "An Empirical Evaluation of Accounting Income Numbers," *Journal of Accounting Research* 6, Autumn 1968, pp. 159–78.

5 For example, Dow Jones News Service (the "Broadtape"), *The Wall Street Journal*, and Dow Jones News/Retrieval usually provide more timely, firm-specific information.

6 M. Ingberman and G. H. Sorter, "The Role of Financial Statements in an Efficient Market," *Journal of Accounting, Auditing and Finance*, Fall 1978.

and creditors and other users in making rational investment, credit and similar decisions" and that financial reporting should help this set of users in "assessing the amounts, timing, and uncertainty of net cash inflows to the related enterprise."[7] Given the state of the art in financial reporting, the foregoing implies that standard setters know what is best for the individual investor, a curious notion, but understandable in the environment of the first half of the twentieth century. It is inconceivable that general-purpose financial statements can provide investors with precisely the information that they might desire.

Yet, the emerging technologies of the 1990s may enable individuals to quickly access financial data bases; for example, multiple sets of information prepared under differing asset and liability valuation bases. Divergent concepts of income measurement might be made available to meet investor information needs. Other possibilities include the recasting of financial information on a constant-purchasing-power basis, extracting a cash-basis income statement, analyzing the impact of capitalizing long-term noncancellable operating leases, and making available the impact of reporting pension liabilities based on a projected-benefits-obligation basis as well as on the presently decreed basis of the accumulated benefits obligation, to mention a few.

The technology needed to move from a single set of general-purpose financial statements to a multipurpose data base containing a variety of information that meets the needs of diverse users is clearly, now, the state of the art. Indeed, systems presentation of data is at a point where the system can learn what the user wants to see, providing any of a variety of formats, and even learn what the user wants over time without the user's requesting it. With this scenario, presentation issues become less relevant. We make no recommendation that general-purpose financial reporting be immediately replaced by the system described here, but only that the proposed system be implemented for a test period to determine feasibility and utility. Perhaps the scenario sketched here could be implemented in an evolutionary way—a general-purpose set of financial statements could continue to be produced and published as a public good, with the availability of all supplementary information and alternatives that investors might require contained in the computerized data-base system—much as the U.S. government is implementing for selected corporate data.[8]

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7 FASB, Statement of Financial Accounting Concepts No. 1, Stamford: 1978.

8 The additional costs of providing user-specific information might be recovered by the sale of accounting information to users who desire it. Free riders would be replaced by those who desire specific information and are willing to pay for it. The market would equate supply and demand. It would rapidly become apparent what information is used by investors in their decision-making processes and might help direct future standard-setting efforts.

One problem arises from this suggestion—which also affects existing financial data bases—namely, the degree of financial integrity that would be present in data bases that purvey financial information. It is axiomatic that such financial disclosure systems must be subject to the attest process. We recommend that the integrity of current and future data bases available to the investing public be subject to independent professional scrutiny.

In summary, we offer the following proposition.

PROPOSITION 4

> Research and field tests should be undertaken to determine the feasibility of developing data bases and systems to permit users to obtain the information they perceive necessary to meet their decision needs in whatever format they may desire, with the expectation that such information would be subjected to the attest process.

Globalization

Perhaps the most challenging issue that faces all accounting standard-setting organizations is the globalization of commerce. The world is becoming a common marketplace in which capital is raised and resources are allocated with less concern about national boundaries. Common information about investment opportunities throughout most of the world is needed to allow resource allocators to make informed decisions. Steps have been taken by the International Accounting Standards Committee (IASC) to address such needs, most notably with its comparability project; however, much remains to be done. Many of the accounting policies in the United States are the product of the nation's cultural, economic, and political environment, and the same is generally true in other countries. Reconciling those diverse views and needs with U.S. national accounting standards poses problems that will not easily be resolved.

There is evidence that non-U.S. companies are avoiding U.S. financial markets because of the perceived regulatory burden, in favor of the United Kingdom, which accepts IASC-compatible financial statements, and other smaller markets such as the Netherlands and Singapore. The global market may accept a financial reporting model that represents the lowest common denominator in accounting and reporting standards, thus defeating the primary purposes of the U.S. standard-setting and regulatory functions, and potentially exposing U.S. companies to an "unlevel playing field" in the global market. For these reasons, the United States must enhance its role in the international standard-setting arena.

The FASB should recognize the trend towards acceptance of IASC standards in a growing number of countries and by important international organizations, such as the World Bank. To the extent that the FASB becomes more involved in the international standard-setting process, it may influence the nature and scope of international standards. Endorsement of IASC standards by the FASB and the Securities and Exchange Commission would bring the world's largest capital market into the fold, would remove or reduce some barriers to international investment in the United States, and would certainly create pressure on other capital markets to follow suit.

The FASB has extensive research capabilities, which could be placed at the disposal of the IASC and other bodies, such as Britain's Accounting Standards Committee, the Japanese Business Accounting Deliberation Council, and the European Community. The FASB should initiate research projects on topics unique to multinational corporations and should cooperate in identifying and developing needed standards in response to emerging issues.

Believing that much is to be gained by the United States' taking a vigorous strategic role in shaping international accounting standards, we propose the following initial step.

PROPOSITION 5

A joint high-level commission (that includes the FASB) should be established by the Financial Accounting Foundation and the Securities and Exchange Commission to define a prudent and timely course of action for the United States in establishing international accounting standards.

The FASB's Mission and Agenda

The long-term viability of the FASB must be of continuing concern to all who believe that the process of standard setting is best served if retained in the private sector. Issues that shape the long-term stability of the FASB include a continuing reassessment of its mission, the agenda-setting process, the primacy of users versus preparers, and financing FASB operations.

Mission

Contrary to intent, the standard-setting process has grown many tentacles since the FASB was established. In 1972, the Study on Establishment of Accounting Principles (Wheat Committee Report), chaired by Francis M. Wheat, made the following statement: "It is essential that financial accounting standards be in only one set of hands—the [Financial Accounting] Standards Board's."[9]

In 1990, what is the status with respect to the establishment of accounting standards, principles, and rules? In addition to FASB Statements, Interpretations, and Technical Bulletins, an accountant is faced with the following:

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[9] AICPA, *Establishing Financial Accounting Standards: Report of the Study on Establishment of Accounting Principles*, New York: March 1972, p. 72.

1. *EITF Abstracts*. Since its establishment by the FASB in 1984, the Emerging Issues Task Force, which was "to assist the FASB in the early identification of emerging issues affecting financial reporting,"[10] has reached a number of *consensuses* that the SEC Chief Accountant expects to be applied by companies subject to the SEC's jurisdiction.[11]
2. *American Institute of Certified Public Accountants (AICPA) Statements of Position of the Accounting Standards Division*.[12] These statements deal with issues not covered by existing FASB pronouncements. The FASB may issue standards to supersede any AICPA statement of position by the AICPA's Accounting Standards Division.
3. *AICPA Accounting Standards Executive Committee Practice Bulletins*. These pronouncements are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board.[13]
4. *AICPA Audit and Accounting Guides*. These guides are intended to be helpful in areas such as determining whether prospective financial statements are presented in conformity with AICPA presentation guidelines.[14] Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Presents Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA guides as sources of established accounting principles that an AICPA member should consider.

The AICPA's role is strengthened by the aforementioned SAS No. 5 and is further buttressed by actions of the FASB described as follows.

> In September 1979, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters* (as amended by Statement of Financial Accounting Standards No. 83, *Designation of AICPA Guides and Statement of Position on Accounting by Brokers and Dealers in Securities, by*

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[10] FASB, *EITF Abstracts: A Summary of Proceedings of the FASB Emerging Issues Task Force*, Norwalk: October 6, 1988, p. i.

[11] Ibid.

[12] See AICPA, *AICPA Technical Practice Aids*, New York: 1990, p. 16,001, for a discussion of the role of AICPA Statements of Position of the Accounting Standards Division.

[13] Ibid., p. 30,515.

[14] AICPA, *Guide for Prospective Financial Statements*, New York: 1986, p. ii.

Employee Benefit Plans, and by Banks as Preferable for Purposes of Applying APB Opinion 20), an amendment of APB Opinion No. 20, *Accounting Changes*. This Statement specifies that the specialized accounting and reporting principles and practices contained in designated AICPA Statements of Position are preferable accounting principles for purposes of applying APB Opinion No. 20.[15]

Clearly, over the years, varied sources for authoritative standards have evolved. It is clear that both the EITF and the AICPA are active players in the establishment of accounting principles, in contravention of the recommendation of the Wheat Committee. As a result, FASB standards are not the single source of standards as envisioned by that committee. If the process continues unabated, the FASB may eventually be relegated to being a minor player.

Accounting standard setters should have a degree of independence that is exceptionally high. While the FASB is organized in such a way as to ensure considerable objectivity in its members, the same is not true for other groups active in the accounting standard-setting process. For example, members of the EITF and the AICPA's Accounting Standards Executive Committee participate in the standard-setting processes of those organizations only part-time, and most are public accountants or preparers of financial statements and reports. While the perspectives and beliefs of active practitioners are vital to the standard-setting process, we believe that those subject to the effects of accounting standards should not be directly responsible for the development of individual standards. We believe that the process is best served if left in the hands of one independent, full-time body. Accordingly, we propose the following.

PROPOSITION 6

A major initiative should be launched to reestablish the FASB as the sole private-sector body with responsibility for setting financial accounting standards. All other private financial accounting standard-setting activities should be cleared through the FASB and be viewed as nonauthoritative.

Unless the primacy of the FASB in the private sector is clearly established, we believe the standard-setting process in the private sector is doomed.

Standard setting in the private sector exists at the discretion of the SEC. Although it looks to the FASB as the primary source of financial accounting

[15] AICPA, *Technical Practice Aids*, New York: 1990, p. 16,001.

standards, the SEC continues to exert significant influence on accounting principles and practices through Regulation S-X and Staff Accounting Bulletins.[16] That the SEC's actions have an impact—salutary or otherwise—on the work of the FASB is clear. While frequently demonstrating its support for FASB pronouncements in its enforcement of the Securities Acts, the SEC often is the court of last resort for publicly owned companies that perforce must seek SEC—rather than FASB—approval of their financial accounting.

Obviously, the FASB, or any other private-sector standard setter, must be ever cognizant of the views of the SEC. To those who are outside this process, it appears that the FASB has handled matters in this area as well as could be expected.

Setting the FASB Agenda

The FASB agenda is the product of a deliberative, thoughtful process, as described by the FASB in its publication, *Facts About FASB*.[17] Although on its face this *agenda-setting* process appears well structured, on occasion topics have been *removed from the agenda* for reasons not entirely clear. For example, accounting for business combinations, which was on the original agenda of the FASB and was the subject of a lengthy Discussion Memorandum, was removed from the agenda "because of [its] low priority in relation to other existing and potential projects."[18] Similarly, the FASB undertook a comprehensive study and issued a Discussion Memorandum on interim financial accounting and reporting, but subsequently abandoned the project.

We believe that removal of agenda items should receive the same thoughtful, careful consideration as was used in placing the item on the agenda in the first instance. We recommend the following.

PROPOSITION 7

> The removal of items from the FASB agenda should receive the same deliberate "due process" as does the placement of items on the agenda, including broad-based consultation. Further, the basis for removing items from the agenda should be fully disclosed to all constituents.

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16 SEC, *Codification of Financial Reporting Policies*, Washington: 1989, Sec. 101.

17 FASB, *Facts About FASB*, Norwalk: 1990, pp. 2–3.

18 FASB, *Status Report*, Stamford: April 10, 1981, p. 3.

Role of Users

If the purpose of accounting is to provide information useful for decision making, then it follows that the role of public financial reporting is to aid external users in making informed decisions. In this context, the standard-setting process ultimately exists solely for the benefit of public users of financial information. Despite the public need that is served by the financial reporting process, many competing variables interact to influence the standard-setting process.

Therefore, in the setting of standards, the views of preparers should always be secondary to the needs of users. In fact, if financial statements are issued to facilitate the securing of capital by an entity, this objective will best be served by responding to the needs of users. When the difference between the cost to preparers and the benefit to users of a standard is marginal, the scales usually should be tipped in favor of users.

The consequences of preparers of financial statements dominating the standard-setting process could not be more vividly illustrated than by the savings and loan industry, where regulatory accounting principles were modified in the interest of issuers at the expense of the taxpayers.[19] To the extent that the process is unresponsive to user needs, it is doomed to failure. Based on this analysis, we propose the following.

PROPOSITION 8

> The interests of users of financial statements should take precedence over the interests of preparers, and therefore the user constituency should dominate the governance of standard setting.

In this context, the focus of standard setting should always be on the benefits to be achieved. Recent calls for shifting the focus to the cost of standards may tend to be counterproductive. Obviously, cost must be considered. Through field testing and other means, a reasonable perspective on the cost of proposed standards may be obtained. However, cost to preparers must not be permitted to take precedence over benefits to users simply because costs are more easily measured.

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[19] Regulatory accounting principles were promulgated by the Federal Home Loan Bank during the 1980s in an effort to increase regulatory net worth reported by savings and loans. These procedures have been criticized as increasing the total cost of resolving the savings and loan crisis. It should be noted that the FASB issued FASB Statement No. 72 (on accelerating goodwill amortization) and FASB Statement No. 91 (requiring deferral of loan fees) during this period. These pronouncements tended to lower the reported net worth of savings and loans.

Financing the FASB

For standard setting to remain in the private sector, a stable funding base must be secured for the FASB. Reliance on voluntary contributions places the standard-setting structure in a precarious position. Corporate contributions, a major source of current funding, may diminish significantly if there is widespread dissatisfaction with particular standards, no matter how well such standards serve the public interest. The potential for such action cast a long shadow over the *independence* of the members of the FASB.

Funding from public accounting firms is also problematic. If the role of the independent CPA is to serve as an information intermediary between suppliers and users of financial information, one could (and many firms do) question the validity of charging CPA firms with a major underwriting responsibility for the FASB. As major contributing firms merge and cost pressures increase, the level of financial support from CPA firms will likely diminish.

Under the present structure, financial information essentially is provided to users as a free "good." Although custom-designed information of the future may carry a user charge, general-purpose information will likely continue to be made available at no direct cost to users because it serves the interest of the suppliers of the information.[20] Assuming that an active, reliable financial market exists in the long run for the benefit of suppliers of information, it may be appropriate for providers of financial statements to underwrite the cost of setting standards, using an assessment system similar to that of the New York Stock Exchange. The ideal long-term solution would be the creation of a permanent endowment, with the interest therefrom being used to finance FASB operations. For the short term, we recommend the following.

PROPOSITION 9

> Consideration should be given to establishing an assessment system to underwrite the FASB by each publicly held company based upon an appropriate measure such as a percentage of total revenues or total assets.

Conclusion

Generally, the FASB has served users well for almost two decades. But as is inevitable, environmental changes necessitate a periodic reexamination

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[20] It could be argued that since the U.S. government is becoming a more prominent user of financial reporting, it, too, should contribute to underwriting the cost of standard setting.

of its mission and role. We strongly believe there are many benefits to retaining the setting of financial accounting standards within the private sector, but we are concerned whether the FASB can maintain the relevance of its product, remain independent in pursuit of its mission, and generate adequate financial support to operate through the next decade. There are serious issues to be resolved, and their resolution cannot wait.

Summary Report of Discussion Session

Financial Reporting

The present financial accounting and reporting model is a version of traditional industrial era practices. It is an accrual, matching, historical cost model which is transaction driven and oriented toward producing statements. The model reflects a stewardship emphasis and the traditional needs of the United States capital markets and has been criticized as lacking relevance. And it has been stated that this model and its product are not sufficient to meet the needs of a global information age.

Two principal discussion questions emerged in the symposium sessions addressing the model for financial reporting:

1. Is the model per se, including its output, appropriate?
2. How broad (general principles) vs. narrow (specific rules) should standards be in relation to a model?

Is the Model Appropriate?

Important underlying perceptions about the current financial reporting model include the following:

a. The demand for relevant information from the model exceeds the supply.
b. It is inappropriate that all users should be subject to the same reporting requirements.
c. All models have limitations. For example we are limited inherently by using a short-term reporting and measuring model for businesses which are continuous.
d. A financial reporting model cannot remove the risks of investment.

One participant, who seemed to best represent the group in the summary session, stated: "You have before you a group that does not want to scrap the model. I think we want more information, more relevant information, but first we want. . . research on different users to find out what it is they need, and, then, we will give it to them with different levels of attestation."

There was near unanimity that transition and change should be undertaken at an evolutionary pace. The "re-engineered" model must be better in that it must accommodate several different levels of users and provide added amounts of relevant information based upon user needs. During the summary session it was noted that, in 1980, an FASB document, *Financial Statements and Other Means of Financial Reporting*, addressed these matters, identifying an information spectrum which relates to the model of core reporting discussed at the symposium. The notion of an expanded concept of reporting was considered appropriate in 1980. The difficulty was providing "definition" to any given section of the model.

An illustration of this reporting model (contained in Figure 1, opposite) depicts a core of financial information which is provided for management operating and control purposes. The reporting system supplies this information, and then additional levels of information are provided about an entity, from internal sources, including data bases. Accompanying this reporting model is a view (contained in Figure 2, page 64) of the possible extent to which external audit and attestation procedures would apply.

Disclosure and Measurement

Such a "core and ring" model would affect both disclosure and measurement because it provides a breadth of information beyond a core report/statement set. This core model would move reporting from general purpose to multipurpose, wherein both the continuous and diverse nature of user needs can be recognized. It would assist in addressing the differences among large public companies, small private companies, domestic entities, and foreign entities as preparers of financial reporting information. To the extent it does so, the model would be disclosure driven. However, it would also be measurement driven to provide more information on values. Also, it would seek to contribute risk assessment and prospective, forward-looking information provided that "safe harbor" incentives were available from regulatory bodies to encourage such disclosures.

A participant suggested that there was at least one point about the re-engineered model that specifically relates to what the FASB can consider currently. They could revisit the purposes of disclosure and the FASB's 1980 *Financial Statements and Other Means of Financial Reporting* materials, attempting to establish what constitutes core reporting and differentiates the other "rings." The Securities and Exchange Commission's views also will be important. A change to a re-engineered disclosure and measurement model would have to be planned, and be purposefully gradual or evolutionary so that the impact could be absorbed without needless cost and displacement. This would permit consensus to be built and also permit the reeducation of existing constituents' expectations and the remodeling of educational mechanisms and entry-level evaluation procedures for future preparers and auditors.

All the participants shared an interest in the discussion of what should be in the core information of the re-engineered model. And it was noted that such a core concept might further require assurances/information about the

FIGURE 1 **Information Scope of Financial Reporting: A Core Model**

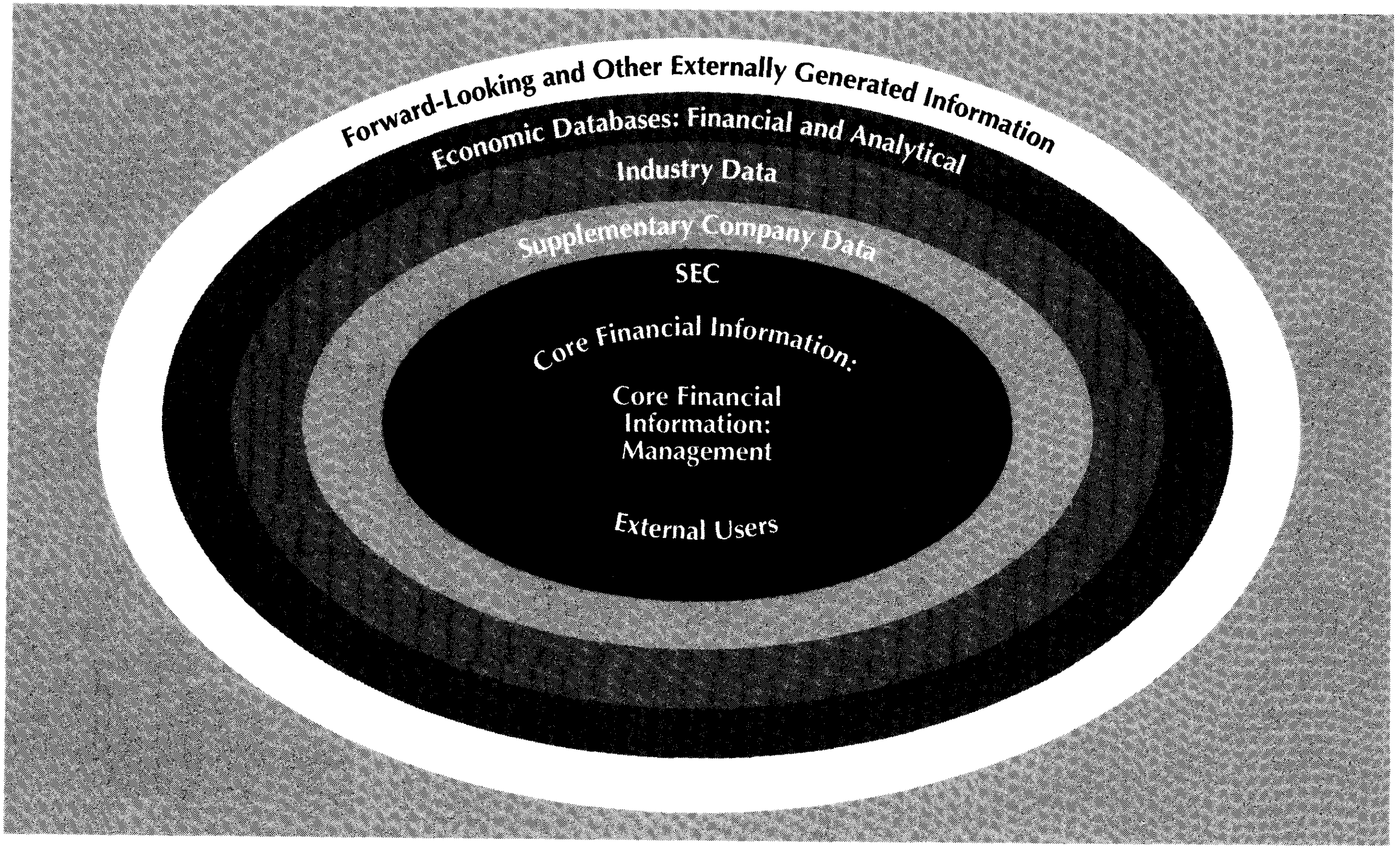


FIGURE 2 **Extent of Audit and Attestation**

quality of a reporting entity's internal information system. As well, it would require agreement upon the extent to which auditing, attestation and safe-harbor responsibilities and areas apply.

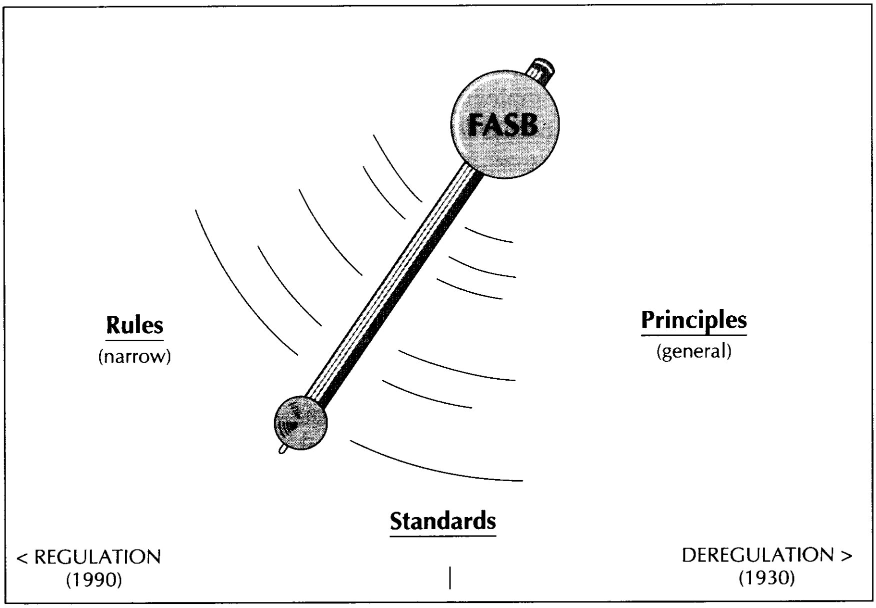
Research also would be needed to assist in establishing the basis of the current core as well as an expected proposed core.

How Broad or Narrow Should Standards Be?

There was a shared perception, commonly referred to in the sessions, that a type of standard-setting "pendulum" exists between the extremes of narrow technical pronouncements (rules) which limit judgment and broad general pronouncements (principles) which afford opportunity for abuse. Ideally, standards should fall somewhere between rules and principles. (See Figure 3, below.)

Early attempts at standards in the period of the 1930s and after were broad-principle-setting efforts to eliminate alternatives; when these efforts began, the pendulum was at one (principles) extreme. The long-standing effort to eliminate alternatives has caused a movement in the opposite direction over several decades so that now, overall, the pendulum is closer to the

FIGURE 3 **A Perception of the Standard-Setting Pendulum**



other extreme with promulgations perceived as rules and with "uniformity" seen as the outcome. Uniformity and rules, some argued, were not the objectives sought of standard setting by the profession when it embarked on the process of limiting alternatives.

Substantial discussion throughout the conference addressed the view of where, overall, the FASB's activity fell along the sweep of the pendulum.

When the FASB acts as a rule maker, it imitates civil law and is perceived to behave as a regulator. When it acts in the broad, general-principles-setting role, it is perceived to be imitating a form of common law, endorsing convention. As a standard setter the FASB is perceived as belonging somewhere nearer a balance point of the pendulum extremes. At this point standards provide guidance for case-by-case field application and professional judgments—a type of case-law guidance.

One example of an extreme broad general pronouncement is FASB Statement No. 5 on liabilities. It affords substantial discretion as a general principle. But, as a general model, it may not always provide a remedy. For, it was noted, in the case of that Statement's application in a political setting that also involved regulatory accounting principles (RAP) and savings and loan issues, the standard did not seem to provide what might have been needed in the situation.

It was a consensus of conference participants that now the FASB has moved too far toward the regulator/civil law end of the pendulum and needs to move generally toward the balance point. Moving generally to reestablish the opposite extreme (principles) was not supported.

In response to the support for this "balance-point" approach, it was noted that concerns about "narrowness" may result from the Board's providing substantial interpretational material. Since at least the issuance of Accounting Principles Board Opinion No. 15, which addressed the calculation of earnings per share, the complexity of application has resulted in increasing requests to authoritative bodies for specific guidance in applying standards to complex capital transactions and situations. If the perception of narrowness follows solely from the inclusion of interpretations in promulgated standards, it may be that the extent and detail of interpretational guidance being given is the issue and not the standards portion of pronouncements. With less interpretation provided in standards, the guidance needed by issuers and users would have to be provided by the preparer and auditor communities, and additional interpretational guidance to users would have to come from the marketplace of analytical services, data bases, and other such providers. Furthermore, FASB interpretational guidance appears to benefit those who audit multiple entities as well as the SEC in seeking consistent application among many different issuers.

Yet it was not a perception of the group that detailed standards eliminate opinion shopping as the SEC might hope. And, the group felt also that the substantial interpretational content of standards, considered as rules, can be seen as a factor which limits individual issuer/preparer discretion. This limitation is particularly frustrating given that major U.S. corporations within their complex, expanding, and global operations are nearly "nation-like" and require substantial autonomy in their operations if they are to compete effectively in global markets. From the perspective of such corporations, this limitation, and their inability to effectively be involved in the process of establishing standards, are a matter of concern.

The group and summary session discussions about the general narrowness of standards reflected an assumption that more judgmental discretion for preparers, users, and auditors also presumed their ability and willingess to accept increased interpretational responsibility and adapt their behavior accordingly.

In additional discussion the group also identified two other areas of particular concern to preparers and issuers:

1. The FASB standards process focuses upon a conservative agenda, namely working on liabilities standards or on standards which tend to reduce the carrying value of assets while not giving equal attention to developing standards for recognizing assets which exist off the balance sheet as well.
2. Standards are proposed without having been field tested as part of the required process of the FASB. It was argued that a rebuttable presumption in the due process system should specify that a field test be conducted by the Board as a part of every major project.

The group sessions also involved consideration of other topics, such as cost benefit requirements, behavior and education, technology, international community requirements, and user constituencies.

Cost-Benefit Requirements. Producing information is an important cost of obtaining and using capital for both large and small companies, foreign and domestic. Will those members of society who are to incur the costs of new disclosures also receive benefits? How would the cost of capital be reduced overall for companies making added disclosures? Possible added costs to issuers and preparers include not only out-of-pocket costs but also costs of disclosing proprietary information which may betray a competitive advantage. Some of the costs which preparers bear are incurred as a necessary and inherent cost of entering the U.S. public capital markets, which are supervised by the SEC under the law. To the extent that SEC oversight of such disclosures influences the detail of their content, they reflect a cost of seeking capital in the public marketplace.

The benefits to society and users are, perhaps, even more difficult to demonstrate or measure. The elusive, intangible aspect of information content and of perceived benefits from added disclosure, if not particularly obvious and readily understood, causes concern about costs to dominate cost-benefit evaluations.

Furthermore, given the difficulties of quantifying and/or demonstrating the benefits, the cost-benefit argument is viewed as having become stalemated and is, instead, often considered a basis for dissent which manifests itself in such responses as "I didn't get what I wanted" or "I don't like the outcome."

How can benefits be better demonstrated? How can a more efficient allocation of investment resources through disclosure be accomplished? Much more research into identifying user groups and their information needs and applications would be needed to provide the basis for any new approach and improvements. This research could also address the role of directors of public companies in identifying such information. For example, it was pointed out that, in conjunction with the project on summary annual reporting, the Financial Executives Institute funded a 1986 study (by SRI, Inc.) on user-group information needs. This study demonstrates the potential for research to obtain such information.

Behavior and Education. It was recognized that, given the existing technical type of FASB standards pronouncements, a shift toward less detailed pronouncements would require changed behavior and place more responsibility upon the auditor and preparer/issuer community for information. As well, as more additional information falls in the outer rings of the proposed core reporting model, the more broad and interpretational it would become. There must be a willingness to respond to this new responsibility and the ability to do so. Given that Rule 203 of the AICPA's Code of Professional Conduct has been available for individuals to apply, and has been almost entirely unused, there is some basis for concern as to how behavior would change with the provision of broader standards. That is, what, exactly, would auditors and preparers do differently, given the discretion currently available under Rule 203?

Technology. It should also be recognized that, in a general move toward balanced standards in a core-and-ring model, attention to the capacity of technology to support new disclosure goals is needed. What is the role of real-time measures and data bases? Given that such information adds relevance, how reliable must it be?

International. A re-engineered model must also be sensitive to growing international community needs. It is felt that the orientation of the U.S. model toward an economic notion of true income is different from the international model's orientation to the balance sheet.

User Constituency. Users are perceived as non-participators in the process, yet they remain a vital and complex constituency most affected by the reports and information content of standards. In frustration, other constituents consider the users' lack of participation as the behavior of "free riders" in the process. They receive the benefits and pay none of the direct costs, it is argued. It is difficult either to identify them or to obtain consistent access to them for necessary input.

The other side of the argument is that lack of complete and relevant information is said to increase the risk which investors/users face and thereby may also limit the pool for investment and total growth in productivity. If this is the case, efficient allocation of invested capital and economic resources is impaired. Therefore, it can be argued that it is in the user's best interest, as well as society's, to seek user involvement even though the SEC is often considered a surrogate for small investors.

Summary Report of Discussion Session

The FASB—Its Mission and Agenda

> The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.

The second topic formally scheduled to be discussed at the symposium was the FASB's mission and agenda. The above paragraph, which is the first part of the current mission statement, establishes the general responsibilities and relationships of the Board. Those responsibilities and relationships, which comprise the mission "process," became a focus of attention at the group sessions. The group sessions affirmed with near unity the importance of retaining the FASB's private-sector standard-setting responsibilities. As one individual stated, "The mission is not the issue."

But it was noted that continued support for the mission and role of the FASB should not be taken as an unconditional endorsement. While the assembled group did not express concern about the FASB's present mission, this does not mean that alternatives could not be found if substantial dissatisfaction with the Board continues. Some, it was argued, may turn to the International Accounting Standards Committee (IASC) or to the government (the SEC or, perhaps, Congress) to seek remedies.

Among the concerns raised at the sessions was whether equal attention is paid by the FASB to reviewing constituent concerns among the specified mission constituents—issuers, auditors, and users of financial information. For, when not all are perceived to be equally regarded by the Board, its market is reduced. As one participant stated, "Who are your customers?" Preparers, it was argued, are customers, too. And, the question arises, Are their concerns sufficiently addressed as users of the "product"? The notion of users in the past has embraced external parties, analysts, and third parties in the domestic public-investing community. However, issuers and preparers assert that they, too, are users in the sense that they are investors of corporate assets and persons who use financial reports to evaluate competitive position and market opportunities in a global context. One participant commented that the FASB does not seem to regard the preparers as a constituent customer. This stance seemed to some to call for clarification of the definition and role of the user community, including consideration of the role of preparers as "customers" of standards. Others cautioned that this call should not be interpreted as more than adjusting to an appropriate level of responsiveness and should not mean any lessening of the resolve of the Board to maintain its independent point of view.

The mission also received attention because it is linked through the agenda to the "product" of standards.

Participants discussed whether or not Board activities are evaluated over time as being consistent with the mission statement. Another comment addressed the perception that the mission statement was general, and therefore, vague. If so, it could not be goal oriented and would not be of assistance to the Board in achieving its mission.

Others commented that a review of the mission statement is warranted for several reasons:

1. The mission may be appropriate for the current operations of the FASB but it may need to be addressed, updated, and/or revised in light of the interest in a "re-engineered" reporting model. The question is whether the FASB can fulfill its technical standard-setting mission and, at the same time, monitor and amend its mission effectively?
2. Two decades have passed since the undertaking of the initial study (Wheat Committee Report) which recommended formation of the Board. Several interim reviews of Board activities have been undertaken. These resulted in operational adjustments in due process, voting procedure, and so forth. However, a comprehensive mission-focused review may be warranted simply because of the passage of time and the corresponding changes which have occurred in the environment and among the constituent groups.
3. The FASB is a mature organization with established practices which warrant review given the pace of change in technology, business operations, and global competitiveness.
4. Systematic internal evaluations related to the FASB mission per se are perceived as minimal, although frequent decisions about mission priorities are made. To the same extent, minimal systematic, post-issuance reviews of some standards, many of which have now been in place for substantial periods, have occurred. Yet a mission precept specifies the need for review of the effects of all past decisions.

Consideration of several other areas related to the mission would likely add to the value of such review and strategic study. Such areas would include the FASB's agenda and its calendar, its marketing efforts, its international role, its capacity for maintaining neutrality, its relationship with other rule-making bodies, and its long-range strategy.

Agenda. FASB Chairman Beresford noted that setting the agenda may be the most important single activity of the Board. Its view has been that "we study issues but rely on others to point out new issues for purposes of establishing an agenda." Spotting such issues so as to insure their timely consideration and resolution is hardly easy. Recent examples might include pollution, broader environmental impact items, and specific industry items such as insurance company reserves.

The prospect of a re-engineered financial reporting model also raises the issue of how present agenda items and prospective agenda item selection might be affected.

Furthermore, balancing the agendas among a variety of existing authoritative entities, most notably the FASB, the Accounting Standards Executive Committee (AcSEC) of the AICPA, and the Government Accounting Standards Board (GASB), adds to the complexity of the process.

Calendar. The timing of agenda items and the pace of consideration affects the ability of participants to maintain meaningful involvement since many, if not most, do not have the resources for, or cannot justify the cost of, monitoring and responding to the FASB in a full-time mode. Given that due process and the related project cycles are lengthy, only those organizations most committed and able to follow projects do so.

Marketing. The need to implement and understand the Board's complex and important actions and standards also raises the issue of the limitations on the ability of its constituents to comprehend and absorb multiple implementations of standards within a certain time frame. The Board has acknowledged that it may have missed opportunities in the past to improve responsiveness and acquaint others with its views. All this is complicated by the fact that major standards projects require substantial amounts of time, in part to respond to due process, while the mission statement per se states that the agenda items will be acted upon "promptly."

Some participants pointed out that the Board does not do enough to market itself and its standards. This concern was not expressed so much as a criticism but to draw a distinction between the Board's concluding its efforts once a standard is promulgated and its having a program for creating a positive momentum for adoption via a marketing mechanism that would create a fuller appreciation of the rationale for a choice and thereby enhance understanding. This marketing effort must be substantial and differentiated from an expanded public relations activity. Participants suggested that the use of forums would both facilitate information interchange and make the public aware of the limitations of the process. Yet this should not be taken to mean that the Board has responsibility for administering standards in the field. This responsibility rests with the individual professional.

International. Concerns exist as to whether or not the mission statement should contain an explicit expression of responsibilities, given international developments. It was observed that the mission statement is silent with respect to the FASB's international role and could therefore be open to interpretation by Board members in any given case.

A need for increasing FASB sensitivity to international matters was tempered with a proviso that doing so should not be part of a process that seeks the lowest common denominator.

Neutrality. The FASB gains its franchise from the support of its constituents and its responsiveness to these groups. It has no legislative authority or popular political mandate except for its legitimate efforts to serve the public and a market-based free enterprise system. The FASB, therefore, operates in an economic role, and its standards have the capacity to transfer wealth among parties in the domestic and international economy. The mission statement, however, seeks to establish standards which are neutral. Is there an inherent conflict between the Board's role and its mission? That is, is neutrality achievable, given the wealth-transfer character of the standards?

Relationships. The mission statement is interpreted to mean, in light of the SEC's Accounting Series Release No. 150, that the FASB's pronouncements are the sole source of authoritative support in the U.S. capital market. Since the outset of its operations, however, the Board has at times found its relationship with the SEC, AcSEC, and, even with its sister organization, the GASB, to be problematic. The activities of the Emerging Issues Task Force (EITF) chaired by the FASB's director of research, also have, since its formation in 1984, affected the scope of Board operations. Similarly, the significance of international issues and the activities of the IASC, currently chaired by former FASB member Arthur Wyatt, suggest that a clear statement of relationships in the current era might be addressed in the mission statement.

Some participants expressed support for the view that the FASB should be the sole autonomous organization with respect to these matters. Others noted that there are substantially different issues to be addressed and so many items requiring attention that a single agency may be precluded from satisfactorily addressing all of the issues.

Long-Range Activities. The Board's mission statement is silent with regard to a mechanism, similar perhaps to a commercial enterprise research and development (R&D) function, for strategically identifying and developing items beyond the current agenda.

The Need for Mission Statement Change

The case for a review of the mission statement raises the question of how such a review should be undertaken, by whom, and when? The specifics of any such review could be undertaken by several entities. The paper prepared by the University of Southern California Financial Accounting Study Group suggests that a high-level commission be established for this purpose.

The participants recognized that such an effort, if undertaken, deserves the highest possible priority and support. They left the session with an increased appreciation of the responsibilities of the Board, a renewed awareness that the Board's activities are vital to our profession, society, and the free enterprise system, and a sense of how difficult these are to carry out.

Appendix A

Participants' Introduction to the Symposium

[This preliminary material was sent to all participants prior to the symposium at the Wharton School in October.]

Symposium on Financial Reporting and Standard Setting, Sponsored by the American Institute of Certified Public Accountants at the Wharton School, University of Pennsylvania, Philadelphia, October 25–26, 1990

The Financial Accounting Standards Board (FASB) was established seventeen years ago. We now have significant experience with the operation of a full-time, private-sector organization setting standards for financial reporting. The FASB has published a conceptual framework that provides general guidance as it deals with individual technical issues. The Board also has developed extensive "due process" and "sunshine" operating procedures to ensure that those interested in financial reporting have the opportunity to follow and comment on each technical project.

Several aspects of the arrangement have been modified over the years, and there have been indications of continuing support for the organization. But there also is evidence that there has been some erosion of that support, particularly within the preparer community. It is time for a select group concerned with financial reporting to consider how well the Board and its related entities have met the expectations of those who established its structure and to update those expectations for the future. It is time for a fresh look at financial reporting and standards in the broadest sense, with emphasis on setting the future course to help ensure the relevance of financial reporting.

The objectives of the symposium are (1) to give those charged with responsibility to oversee and operate the standard-setting process the benefit of insights and advice of leaders of the business, investment, accounting, and governmental communities regarding FASB structure and effectiveness and (2) to discuss the role of financial reporting and how standard setting should operate to support and enhance that role.

Discussion Papers

To focus the discussion, authors have been asked to prepare brief, nontechnical discussion papers on each of the major topics of the meeting.

The papers will be distributed to all participants several weeks prior to the meeting.

Discussion Topics

Topic I: Financial Reporting

This session would address the following major issues:

1. What are the most important issues to be addressed by standard setters in the near-term and long-term future?
2. What effect will the increasing globalization of the marketplace have on financial reporting?
3. Are the concepts underlying financial reporting appropriate in today's and tomorrow's marketplace? (e.g., Is there too much emphasis on the balance sheet so that the income statement is less meaningful?)

Among the more detailed questions that may fall under this topic are the following:

a. Is financial reporting still as relevant as it was thought to be in the 1970s? For example, have the increased volatility and liquidity of markets for currencies, the emergence of new types of financial instruments, merger activity, and inflation created a need for changes in financial statements or in financial reports outside financial statements?
b. How will changes in information-processing technology (such as the wide availability of data bases of financial information) change the traditional role of financial reports and financial statements?
c. Have there been changes in the economic and financial reporting environment since 1973 that call for changes in the structure or operations of standard setting?

Topic II: The FASB—Its Mission and Agenda

This session will deal with issues more directly related to the FASB's activities, including the following:

1. Is the Board achieving the right balance between the theoretical and the practical? (And what do those terms mean?)
2. Is the FASB's mission statement [page 79] appropriate? If so, has the Board been fulfilling its stated mission?
3. How is the Board's agenda set? How should it be set?

Among the more detailed questions that may fall under this topic are these:

a. What were the reasons for establishment of the FASB? Has the Board been responsive to problems perceived when it was established?

Appendix B

FASB Mission Statement

[This statement is taken from official materials of the FASB, 1990.]

The Mission of the Financial Accounting Standards Board

The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.

To accomplish its mission, the FASB acts to:

1. Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
2. Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
3. Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process; and
4. Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards.

Concepts are useful in guiding the Board in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also will help the public to understand the nature and limitations of information supplied by financial reporting.

The Board's work on both concepts and standards is based on research conducted by the FASB staff and by others. The Board's activities are open to public participation and observation under the "due process" mandated by formal Rules of Procedure. The FASB actively solicits the views of its various constituencies on accounting issues.

The Board follows certain precepts in the conduct of its activities. They are:

- *To be objective in its decision making* and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.
- *To weigh carefully the views of its constituents* in developing concepts and standards. The ultimate determinant of concepts and standards, however, must be the Board's judgment, based on research, public input, and careful deliberation, about the usefulness of the resulting information.
- *To promulgate standards only when the expected benefits exceed the preceived costs.* While reliable quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will fill a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.
- *To bring about needed changes in ways that minimize disruption to the continuity of reporting practice.* Reasonable effective dates and transition provisions are established when new standards are introduced. The Board considers it desirable that change be evolutionary to the extent that can be accommodated by the need for relevance, reliability, comparability, and consistency.
- *To review the effects of past decisions* and interpret, amend, or replace standards in a timely fashion when such action is indicated.

The FASB is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on financial information. The Board believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances similarly and for different transactions and circumstances differently.

b. Should the Board be devoting more effort to defining and obtaining consensuses on the underlying concepts of financial reporting?
c. A specific objective included in the mission statement is neutrality of the information in financial reports. A frequent line of comment on Board projects deals with the economic consequences of proposed standards. Do these two ideas conflict?
d. How can the Board better manage the pace of change in financial reporting? How can the Board tell when an appropriate balance has been struck between needed improvements and stability? What are the challenges facing the Board in the future? What actions can be taken to ensure real support for the FASB?

Postscript

A summary of the proceedings will be published. The Financial Accounting Foundation or the FASB would follow up on any specific ideas for changes that might emerge from the meeting, either by considering such changes themselves where appropriate, or by making sure the ideas are communicated to the trustees or other bodies involved.

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